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Book Reviews

PRINCIPLES OF AUDIT SURVEILLANCE

By Harvey Cardwell. D. VAN NOSTRAND COMPANY, INC., Princeton, N. J., 1960. Pages: x + 465; $9.00.

Almost daily a newspaper, magazine, newsletter or technical or trade publication contains an article or statistics on employee thefts. The estimate of annual losses from this source steadily mounts.

At the same time, the public accounting profession continues to go to great lengths to make clear that an examination of financial statements performed in accordance with generally accepted auditing standards is not designed to uncover inside thefts, and, therefore, the independent accountant ordinarily should not be held responsible for failure to uncover defalcations.

The independent accountant may be happy to learn that the author of the Principles of Audit Surveillance agrees with him. At the outset he points out that procedures utilized in the examination of financial statements and procedures designed to detect inside theft are fundamentally different. He explains further that the failure to understand and appreciate the differences has baffled the accounting profession and confused businessmen and the public.

Simply defined "audit surveillance" is a program designed for the specific purpose of detecting embezzlement. Such a program could be conducted by the independent accountant, internal auditor, or both.

Following a general introduction are two main divisions—Theoretical Concepts of Inside Theft and the Practice of Audit Surveillance. Under the first heading, the author analyzes in considerable detail the various types of inside theft and follows each one through from the theft act itself, to manipulation of the records, and finally to realization on the stolen asset. Along the way he coins and defines new terminology to an extent that it was necessary to include a 17 page glossary for the reference reader. Between the new terminology and the detailed bookkeeping discussion, many readers would become lost and bored if it were not for the many actual fraud cases which are presented. A reading of the cases is recommended for the experienced as well as the inexperienced auditor. A refresher may be jolting to the former group, and the latter group should have their eyes opened and their horizon broadened.

The second main division of the book covers the surveillance program and techniques. The author states that audit surveillance as proposed is "a new specialized function of public accountants and of internal auditors." However, most experienced auditors will find much of the material familiar. Nevertheless, there are few who would not benefit from a thorough review in this area. This reviewer was especially happy to find a discussion of "The Technique of Oral Inquiry," as the efficacy of oral techniques have been so often discounted or overlooked.

The author presents his book as a challenge to the public accounting profession "to reappraise its position with regard to inside theft and to assume additional duties, responsibilities, and liabilities in an area where only the accountant is qualified to function." Although the accounting profession, in connection with the examination of financial statements, may not be primarily concerned with detection of inside thefts, many accountants have had experience in the detection of fraud as a special assignment. Perhaps the accounting profession should ac-

cept Mr. Cardwell's challenge and expand its thinking and activities in this area.

"Principles of Audit Surveillance" is designed for the student as well as the practitioner. This reviewer for one has grave doubts as to its value as a textbook. However, he recommends it as required reading for all those with one or two years of auditing experience and as a valuable refresher course for the more experienced auditor.

CHARLES B. HELLERSON, CPA
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ACCOUNTING IN BUSINESS DECISIONS

By Homer A. Black and John E. Champion, PRENTICE-HALL, INC., Englewood Cliffs, N. J., 1961. Pages: v + 812; $10.60.

The introduction to accounting written by Black and Champion is an obvious response to the challenge of the Gordon and Pierson survey reports. Both of these surveys of higher education for businessmen urged that accounting be taught on the undergraduate level as a management tool and not primarily as a profession. Black and Champion's book has undeniable merit. In fact it is so good that, in spite of my philosophy about introductory texts, that they should not be streamlined, survey courses, I find myself wishing that I had written it—which is probably the highest compliment I can pay to the authors. Having struggled through several different survey introductions with irascible freshmen, it is certainly a pleasure to see a textbook with an integrated purpose.

The purpose is pursued without deviation. After a brief consideration (some 250 pages) of the technique of accounting, the authors launch into a section on "Measuring, Planning and Controlling Income and Working

Capital," containing chapters on the assessment of operating results, planning future operations, and a quite excellent chapter on operating budgets. Planning and controlling cash, receivables and inventory are considered, as they should be, from the point of view of achieving the goals specified in the budget. Part 3 deals with long-term assets and equities, also oriented to the goal-achieving thesis. The text is completed with a section on appraisal of business results, closing with a chapter entitled "Reappraisal of Accounting," which refers briefly to current areas of controversy.

Two features of the book will interest and challenge instructors of accounting: cost accounting is introduced as a tool of inventory control, and not left to dangle in a few isolated chapters at the end of the book—where in the words of Stigler, "they may be more conveniently ignored"; and statement analysis is carried throughout the text. Some of the material presented may appear a bit recondite for an introductory text, the emphasis on compound interest mathematics in Chapter 21, for instance. But the authors can justifiably reply that the time to put that tool to work is right when the students have learned it in their freshman course in mathematics. I am very annoyed with my seniors in theory courses, who think it an imposition that I require them to relearn the formulae—and who take great umbrage at my insistance that they know how to derive them.

There are two more features of the book to which I would like to refer: one is the de-emphasis but not omission of the worksheets—they are relegated to appendices of the chapters to which they relate; the second feature is the replacement of accounting sets by cases, many of which are very interesting. I cannot approve of the first of these innovations; I am old-fash-

ioned enough to regard the work sheet as basic, the opinion of Professor Pierson et al notwithstanding.

The second feature I heartily endorse. There seems to be no sense in requiring sets; if they are properly done, they serve as excellent exercises in patience and endurance; if they are co-operatively done, the degree of adequacy in the performance is a measure of the students' social organization; if they are simply copied—which in the majority of cases they are—they serve no purpose except to make work for the janitorial staff who must remove the rubbish from the departmental offices. Cases can be discussed in class, and they might even arouse the interest of the students, which is a consummation devoutly to be hoped.

One more word—if this book represents an indication of the direction in which we are going with our introductory couses in accounting, one question is definitely answered for me. There is an absolute necessity for the retention of the course in intermediate accounting. Neither this book nor any of the other survey introductions will permit a student to leap immediately into an advanced text. This is the consequence of a survey introduction; actual grounding in fundamentals must be deferred to the intermediate course.

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THE PLAYSCRIPT PROCEDURE:
A NEW TOOL OF ADMINISTRATION

By Leslie H. Matthies, OFFICE PUBLICATIONS, INC., in cooperation with The Foundation for Administrative Research, 1961.

This book, with an ingenious title, provides a unique method for procedure writing. A major problem in today's complex corporate structure is

that of communication. An important segment is the development of uniform procedures to guide employes in performing the work assigned within the framework of an overall system.

"Playscript" recommends the use of plain understandable English as opposed to language described as "Procedur-e-z-e" and likens the procedure documents to the script of a play and the employe to the actor on the stage following the script. The object of the script is to get people to do something, i.e., "to play a part." It tells the actor when to do what. So it is with the corporate procedure, which should say who does what and when. This must always be kept in mind and, also, that a procedure is not intended to tell the operator how to do the work.

In developing a format for his recommended method of procedure writing, the author made a further novel move in borrowing from the kitchen the simple form used in writing a recipe for food preparation. The author explains that the recipe tells in logical sequence and in simple understandable language exactly how to proceed—the material to be used and what to do with it. A model format for a procedure on the "Playscript" pattern is provided together with a description of the basic elements of the procedure. The format encourages the writer to think of the logical sequence of the work to be performed, "boils out excess words" and promotes coordination. It also induces a uniformity of style rather than a variety and thus, as the author points out, gains quick recognition among the employes once they have become accustomed to the form.

Emphasis is placed throughout on the use of "action words" and "verbs in the present tense," whether the procedure is merely a job outline for an individual or one requiring group action. Elements of good procedure are

set forth and readability is rated above correctness. A sample vocabulary of action words is provided and a suggested list of verbs most commonly used in procedure writing with a translation of these from "Procedur-e-z-e" to Plain English.

The final chapters contain valuable information about common errors and how to avoid them and suggestions how to maintain and distribute procedural manuals and up-date those in the hands of personnel using them.

The book is an excellent one for reference by a CPA firm in the preparation of audit programs, questionnaires, and other instructions, and by firms providing management services. The author is to be commended for this valuable contribution to the literature on good management.

EARLE L. WASHBURN, CPA
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THE PRESIDENT'S PAGE

The State-Wide Chapter Conference

The present health and vigor of our Chapters, and the promise of even greater strength and service to our members and the public in the future, are of paramount importance to our profession. These vital qualities were clearly evident at the Second Annual State-Wide Chapter Conference held at Rochester this past summer. Arranged by Don Margolis, Chairman of the Committee on Chapter Operations, it was attended by the President and other officers of each Chapter. The Society was represented, at the invitation of the Chapters, by our First Vice President, our Executive Director and your President.

The Conference was a round table discussion, conducted informally, which began with each Chapter President telling what his Chapter had done during the past year and what it planned to do in the present year. This made for a healthy interchange of ideas and brought up for discussion many Chapter problems with suggestions from members who had similar experiences. This pooling of experience greatly assisted in solving some of the problems presented.

To this observer it was most interesting to hear how each Chapter had independently developed its own particular program designed to meet its own special needs. Significantly, there were some topics of such common importance or interest that several Chapters were planning meetings or seminars on them.

One of the most promising subjects of common interest was Professional Development, that is, a pro-

gram designed to raise even higher the level of competence and professional standards of our members. Several Chapters planned to have seminars or sessions on various subjects in this area, one Chapter using the physical facilities of a local college. Professional fees will be a favorite topic for such meetings. Relations with the Society and cooperation between it and the Chapters were discussed frankly and, as a result, there will undoubtedly be a better understanding of mutual problems.

The State-Wide Conference was an ambitious program, requiring a full day and covering such subjects as Growth Problems of Young Chapters, Requirements for Membership, Administering the Chapter Budget, Coordination of Chapter and Society Committees, Ethical Problems Involved in Telephone Directory Listings, Cooperation with Other Organizations, Appraisal of the Guide for the Operation of Chapters, Suggestions for More Effective Chapter Management, Use of Public Relations Clinics, Importance of Communications, Development of Future Chapter Officers, Meetings between Chapters and Use of First Vice Presidents in Chapter Management.

In addition to these important and stimulating topics there was a long discussion on the effective use of AICPA programs. These study courses include: Furthering Education, Staff Training Programs, Management Services, Data Processing, Personnel Recruiting, Accounting Principles and Auditing Procedures. Individual Chapters expressed their preference for one or more of these subjects depending upon professional needs in their Chapter areas.

One could not help but be greatly impressed by the free and candid discussion, by the fine spirit of friendliness and cooperation shown among the various Chapters and by the breadth and vision of their planning—all of which augurs well for the future of our Society and the profession.

EDWARD J. BUEHLER, CPA
President

Scope and Administration of Management Advisory Services

By NORMAN J. ELLIOTT, CPA

Management advisory services are a "growth industry" within the accounting profession. However, the process of initiating or expanding such services is not without challenges and trials, and should not be taken lightly. Some advice and words of caution are here provided from the ample background of the author's experience.

SCOPE

Consideration of the administrative techniques for controlling the professional practice of Management Advisory Services (hereinafter sometimes referred to as MAS) by certified public accountants must start with some understanding and definition of the range of services and techniques intended to be included under that single descriptive title. Since all professional accounting is a service to management, some portion of it must be excluded from the specialized area under discussion. The scope of MAS includes, broadly, those activities and services of professional accountants which are designed to assist managements in planning the operation and control of enterprises and which provide specialized data to assist in the decision-making process.

NORMAN J. ELLIOTT, CPA, is a former chairman of our Society's Committee on Management Services, and a member of the counterpart AICPA committee. This article has been adapted by the author from a talk given by him at the Society's 1961 conference at Whiteface Inn, Lake Placid. Mr. Elliott is a partner in the firm of Anchin, Block & Anchin, certified public accountants.

Examples of services directed to management control and decision-making, in two groupings, are as follows:

SERVICES DIRECTLY RELATED TO ACCOUNTING

Financial Planning
Capital Procurement
Capital Budgeting
Organization Planning
Operational Budgeting
Cash Budgeting
Inventory Management
Cost Controls
Pricing and Price Administration
Control Methods and Procedures
Clerical Work-loads
Management Reporting

SERVICES NOT DIRECTLY RELATED TO ACCOUNTING BUT WITHIN THE CAPABILITY OF TRAINED CPAS

Plant Relocation Studies	Engineering and Research Controls
Marketing and Market Administration	Operational Capacity Studies
Sales Administration	Job Evaluation
Personnel Administration	Incentive Systems
Materials Handling and Storage	Ratio-Delay Studies
Plant Layout Studies	

The MAS scope, is, as a practical matter, that of management itself, namely the control and effective employment of money, people and things. It follows, then, that MAS is the consulting and advisory activity of our profession which is directed to providing investigative and analytical talents with respect to the operation of enterprises, for the purpose of evaluating and suggesting improvements in the use of money, people and things.

Management of Money.—The management of money involves operational and cash budgeting, short-range and long-range financial planning, and developing tactics and presentations to aid in the procurement of credit and capital.

Management of People.—The management of people relates to such matters as personnel administration, study of clerical workloads, labor cost analyses and controls, production scheduling administration, and systems and procedures of all kinds.

Management of Things.—The management of things includes such activities as inventory management, capital budgeting, machine-time capacity utilization, materials consumption and waste control, materials handling costs and space-cost utilization, among other things.

FLASH REPORTING

In working within the scope of MAS, a particularly effective and sensitive service that can be rendered by management-oriented accountants is flash reporting to management. Entirely too often, in attempting to function thoroughly in MAS, some accounting technicians are prone to over-elaboration of procedures, over-particularity with respect to extended analysis of insignificant fractions and decimals, and overwhelming bulky reports. It is the heart of the concept of successful MAS practice that the practitioner understand that his scope is to inform, to instruct, and if possible, to stimulate prompt and effective management correctives, within the minimum effective time. To do this, every enterprise must be subjected to study aiming at developing a segregation or isolation of the *key facts* which are most directly correlated to profit or loss results. These facts must then be accumulated and reported in the simplest manner possible and well within the maximum time-lag tolerance for effective remedial action.

ADMINISTRATION

The administration of the practice of management advisory services by Certified Public Accountants must start with a principal competent to supervise this practice professionally and who has the time and the will to deal with—

- what is to be done (the jobs)
- why they are to be done (their rationale)
- when and in what time they are to be done (scheduling and time costs)

- how they are to be done (work programming and techniques)
- who is to do the work (staffing the jobs).

As a practical matter, the scope of these administrative efforts is such as to suggest, in the more than minimal practice, the delegation of major field supervision to a qualified subordinate. If one is not available, such a man should be trained to assume the responsibility. It is highly impractical to try to combine the supervision of management-type engagements and practice with the routine responsibilities and deadline requirements of audits and tax return preparation. The kind of thinking attitudes involved in each area do not mix, and deadline pressures tend to destroy the thoughtful concentration that successful management practice requires. It is for this reason that both professional and administrative supervision of management services activities should be concentrated in specialized and otherwise unassigned people.

STAFF QUALIFICATIONS

The essential qualifications for staff personnel are—

- major study concentration in accounting, with some management or industrial engineering at the college level;

- personal attributes of controlled aggressiveness, diligence, persuasive abilities, poised address and logical expression both orally and in writing. In addition, the staffman must be flexible and resourceful in thinking, must possess a natural curiosity and have a tendency to look for causes and reasons;

- business experience involving work on problems of organization, operations or planning. Some or all of this experience can be developed through professional auditing and service activity or in staff assistance duties in business organizations.

Desirable additional qualifications for the management services staffman are—

- advanced (postgraduate) study in accounting, economics of engineering, management technique and policy, systems and procedures, etc.;

- experience in methods and procedures, management consulting or controllership;

- several or more years of intensive audit experience in engagements emphasizing internal controls study in medium or larger-sized organizations.

STAFF PROCUREMENT

Audit staff personnel, for the most part, are almost wholly untrained in the techniques required for MAS, and have been molded into frames of mind not easily adapted to recognizing the elements of managerial thinking and decision-making. This is not to say that such people cannot be trained or developed for this purpose, but merely that they are not a ready source of appropriately qualified manpower ready to function.

The nature of academic training in the schools has been such that preprofessional accounting students are not usually exposed to industrial engineering or management theory and practice. Qualifications for practice, and examinations for the CPA certificate likewise have remained devoid of requirements in those areas. Consequently, the usual sources for recruiting personnel should not be expected to provide qualified management services personnel; rather the practitioner should develop carefully selected staff men for training and specialization.

Some practitioners have employed people experienced with non-accounting management consultants or in

industrial engineering firms. Except for the rare find who was trained as an accountant before acquiring this other experience, these ventures in employing "consulting" staffmen have been mostly unsatisfactory. Few of these people have demonstrated a real sense of professional responsibility and almost none can be trusted to be their own discriminating fact-finders in financial and accounting areas. Those technicians who could function in particular phases of the management consulting field, were capable in areas that the professional accountant could not ordinarily properly supervise.

A fairly good potential source for partly qualified people, whose training cycle might be short enough to be economic, is among accountants who have been professionally trained and experienced and who moved into controllership or internal audit functions in private industry. Such people have the basic training in our profession, together with some exposure to management needs, operations, data analysis and thinking. They may have had more experience in dealing with costs as a tool of management, and budgetary control or systems and procedures effort as a way of doing business.

Generally, you will find that professional staffmen with some non-accounting experience or training in any field, even one as foreign to management economics as law, have a greater built-in capacity to break out of the stereotyped rut of routine auditing and scorekeeping accounting. Also, the people who have been exposed to managerial practice in industry above the minimal-sized company level, have learned something of the techniques of working with the end-product of accounting as the input for managerial economics. Other than trying to "mine" talent in these two groups, there is no short-cut to finding and developing staff. The safest route is the longest and most expensive in terms of initial investment—hiring staff with superior initial qualifications, and training them over an extended period of time. Someone, obviously, must be on hand to do the training and supervising. A principal may train himself to assume this role, given enough time. Some mergers in the profession may have been due, in part, as a solution to this problem.

STAFF TRAINING

The outline of qualifications for MAS staff personnel might appear to all but large organizations as making it impossible to obtain the kind of men that will measure up to the requirements. The small or medium-sized firm or individual audit practitioner need not quail at this prospect, since most of the qualifications are present in the makeup and experience of a competent practicing certified public accountant, and those that may be missing can be acquired by directed study, training procedures, or disciplined self-study. Some or all of the following suggestions can be applied to produce increased competence in staffmen and principals alike:

- Concentrated reviews of internal controls studies in the context of audits in diversified industrial enterprises.
- File study reviews of special reports on systems and client problem investigations.
- On-the-job training in special problems study engagements, under the supervision of top staffmen or partners.
- Special study courses on systems, business machines and management-oriented subjects.
- Reading programs derived from selected bibliography, as for ex-

ample, such compilations as are available from AICPA and the NYSSCPA.

- Supplemental readings in specialized periodicals, business-machine manufacturers' literature, etc.
- Library and subject-file accumulation, and cataloguing of files and reference resources in your own firm or practice, as a collection of all the prior experience of your office in special engagements and matters.
- "Goodwill" internship surveys of clients' operations and organizations at minimum audit rates or without charge (more or less as each situation may allow) by the trainee as a check on client control deficiencies. These operational-type surveys may be developed along guidelines laid out in questionnaires. (A survey questionnaire for this purpose may be found in the AICPA Management Services Bulletin 6 entitled "The Review of The Management Controls of the Small Business.") Such operational surveys, moreover, may be useful in conjunction with regular audit engagements, or as a "goodwill factor" in services rendered to clients under retainers.

CONSIDERATIONS IN UNDERTAKING AN ENGAGEMENT

Aside from providing and controlling manpower, the most critical elements in successful management services practice involve the thinking, planning and client relationships developed before engagements are started. Except for straight consulting work in the nature of "brain-picking" and preliminary diagnostic surveys, no engagement should be undertaken until and unless you have established clearly in writing its detailed scope or limits, a description of the job elements and the specific objectives. If you are unable to do this, it is most probable that you do not know enough about the situation to deal with it effectively. At that point, either arrange for more preliminary study, more discussion, or back away from the assignment unless you and the client specifically agree in advance that you are to engage in an exploratory survey.

You should also discuss fully with the principal the extent to which phases or portions of the contemplated effort shall be assigned to his personnel, and the extent to which such personnel must be available to you. You must also arrange for a representative of management, with adequate authority, to be responsible for working arrangements and supervision of the activities of client's personnel.

In the course of pre-retainer activities you will be faced with the necessity for discussing fees, for estimating the time requirements of the engagement and possibly for reviewing the potential results from the effort. It will be impractical to estimate timing and manpower applicable to the assignment unless you know enough about it to prepare some sort of working program or schedule outlining the specific steps and the time needs for each. It follows then, that a fee quotation or time deadline discussion with the client would be hazardous without pre-planning the engagement to some extent.

Fee Quotations.—With respect to fee quotations, it is most important to realize that the area of management advisory services is even more susceptible to "the people problem" than auditing, so that a fixed fee should be avoided. With respect to time charges, the hourly or daily rates used by experienced management services people are established at prem-

ium levels to absorb higher salary scales, greater training and unassigned time, and the higher economic values inherent in managerial planning and service. Consequently, scales for this phase of practice usually range from 120% to 175% of the fee-time charges of comparable audit staff, supervisors and principals. You must therefore deal as much as possible in terms of time-charges and time estimates rather than in lump-sum dollar figures. It is also important to arrange in advance for the scheduling of payments during progress of the engagement, to ease the psychological problem of "the big bill" at the end of an effort of uncertain duration which is likely to be extended by scheduling and work co-ordination struggles with client personnel, and other conditions not reasonably predictable in advance.

THE RETAINER LETTER

As an incident to accepting or "closing" an engagement, a comprehensive retainer agreement or confirming letter should be transmitted to the client prior to the performance of any portion of the assignment. This should cover all the elements developed in the course of pre-retainer investigations, conferences, analyses and discussions. The following are the recommended contents:

- Statement of the specific assignment and its objectives.
- If practical (and safe), a detailed summary of the elements, segments or steps in the engagement.
- Scope and limits of the job.
- Factual statement of the nature and extent of required co-operation and assistance for which the client's management and staff will be responsible.
- Fee scales; time estimates in reasonably safe minimum-maximum ranges; method of billing and payment schedule.
- Disclaimer of specific results with appropriate explanations of the reasons therefor.

ENGAGEMENT ADMINISTRATIVE CONTROLS

Running the job successfully requires the application of control routines similar to those involved in a substantial audit. There should be an engagement plan or work program to be used as a measure of the effectiveness of the field activities. The man or staff group on the job should maintain individual job-logs, and the time reporting should be in such form as to permit the matching of actual work with the plan.

The purpose of an individual job-log is to provide a basis for knowing or explaining, in terms of time-charges, or with respect to information sources (people, records, files, etc.), what each man did, when he did it, whom he may have interviewed or worked with, etc. This may prove to be an invaluable record should a disagreement arise.

Just as it is good policy to bill and collect fees as an engagement proceeds, it is likewise sound procedure to keep the client informed, regularly and currently, of the progress of the job. Weekly reports are usually best. The procedure could be a condensed memorandum of items together with an oral briefing. Alternatively, a short-form reporting letter or summary could be presented routinely. In either event, difficulties and problems (but not petty grievances) should be exposed, facts being relied upon as major premises should be reviewed, and the client should be involved as much as possible mentally, at all points, in a constructive manner.

Reporting on the engagement at the end could be in the form of either an extensive and elaborate report; a short announcement of job completion and results, if any; or something in between. The soundest approach ordinarily would be to prepare a report to advise of completion, to accomplish an orderly and understandable presentation of essential data, and to state conclusions or recommendations. A draft of the report should first be discussed with client's personnel and management where appropriate, and not published until all misunderstandings or resolvable differences of opinion have been ironed out.

DEVELOPING YOUR RESOURCES TO SERVICE CLIENTS IN MAS

The field of management advisory services is extremely broad, so much so, in fact, that few if any practitioners would have the temerity to claim competence in all areas. Consequently, it should be your goal to decide wherein you or your organization is best qualified to function professionally. To that end, a complete review of past efforts in a practice should be undertaken to create a "case" library of special reports and files. Likewise, a searching look should be taken among staff assistants, associates, and introspectively within yourself, to see if there is any specialized industry knowledge, job know-how and technical competence to deal with any phase of management controls, information systems, or managerial economics. This is a first phase,—a marshalling of resources.

A second step in this direction is to arrange for the channeling of all MAS knowledge and effort within your practice through one person or one group. This not only permits specialized administration but also the cultivation of a concentrated reservoir of knowledge and experience. If it is diffused throughout even a small organization, the resultant ability of that organization in the specialized field is disproportionately weakened.

REFERRALS

If the marshalling of MAS resources and the concentration of such knowledge indicates one or more areas of special competence, as well as a clear lack in others, it would be wise to consider the value of referral efforts within the profession. This need not be a one-way street, if there are skills to be interchanged. In any event, however, most MAS projects require fact-finding activity and an understanding of a client's thinking, foibles, prejudices, abilities and limitations. Thus, if you should face the need for specialized support from another practitioner or firm, there is no reason why you cannot reserve for yourself these underlying information activities. In this way, you can participate in the engagement, while appropriate observation of professional ethics and an exchange of assurances in referral letters can protect your economic stake in the client situation. This has been done successfully in tax practice and in SEC matters; therefore why not in MAS practice?

GENERAL THINKING

Establishing and managing an MAS practice is not too much different than establishing a tax department. The fundamental needs can be re-stated as:

- a will to deal with the subject
- devotion of time and effort to study and training
- investment of time and money into source materials, a library, and staff development, and
- concentration of effort in specialized personnel appropriately supervised.

MAS practice is best run by a good "generalist" in the field, rather than a narrow specialist such as, for example, a "systems" man. The broad-gauged type will know that the field relates to analysis and diagnosis of facts and control methods bearing on the management of money, of people and of things, and that each broad area is involved with and interdependent on each other. He will recognize that sound MAS practice requires a recognition that certain kinds of problems and clients should be left to others, that the limitations of practicality in planning a problem solution, and that the limitations of performance within the deficiencies of "the people problem" must always be considered in deciding whether to undertake an engagement.

In sum, however, with this kind of man as technical and policy supervisor, and with the observance of necessary pre-retainer activities and suggested procedures for controlling engagements, MAS practice should be readily manageable.

TODAY'S PARADOXES

What approaches will business adopt in the 1960's? The need for fundamental improvement in the effectiveness of private enterprise will become increasingly evident in this decade. We face major paradoxes on all fronts. We must compete against growing communist economic and military power, yet maintain our living standards. We must aid uncommitted nations, yet guard our monetary reserves. We must boost exports against mounting foreign competition, yet increase wages. We must pay for new federal aid in health, welfare, and education, yet offer tax incentives to stimulate economic growth. If positive action on these problems is not taken soon, these paradoxes could bury us, reversing in the second half of the twentieth century the position of eminence we have won during the first.

As productivity increases, more is produced for less. Those who remain fully employed enjoy more and better goods and services. Those displaced by technological advance and other means of enhancing productivity remain to be assimilated. Even if we could evolve a politically acceptable pattern to distribute less work and more leisure, we dare not thus indulge ourselves while poverty surrounds us in so much of the world. Moreover, labor is coming to realize that featherbedding is only a protest, not a solution. Hence, the creation of new enterprise is fundamental to overcoming structural unemployment and, at the same time, servicing the new demands of both our international responsibilities and our domestic aspirations.

HARRIES-CLICHY PETERSON, "A Tonic for Enterprise,"
BUSINESS HORIZONS, Summer 1961

Applications of Subchapter S to Real Estate and Construction Companies

By Stanley B. Grey, CPA

The tax option offered by Subchapter S of the Internal Revenue Code may be deemed by some to have little value in the field of real estate because of the severe restrictions placed on such companies. However, there still are benefits available, as disclosed in this article, for those who are well informed and can move deftly.

A corporation that qualifies as a "small business corporation" under Subchapter S[1] of the Internal Revenue Code may elect[2] to be treated as a "conduit" by passing its income and/or losses through to its shareholders without any corporate tax burden. However, this new relief provision is not available to a "small business corporation" that has rent receipts totaling more than 20% of its gross receipts.[3]

Since this 20% rental limitation prevents most operating realty corporations from qualifying under the subchapter, a determination of what constitutes rent for purposes of Section 1372 is in order. The regulations[4] state that "rents" as used in this subchapter consist of ". . . the amounts received for the use of, or right to use property (whether real or personal) of the corporation, whether or not such amounts constitute 50% or more of the gross income of the corporation for the taxable year." The Commissioner thus applies the classic dictionary definition of rent to the subchapter and at the same time clearly states that the personal holding company escape route for rents that equal 50% or more of gross income[5] is not available to realty corporations under Section 1372.

The regulations[6] further state that where "significant services" are rendered, in connection with the occupancy of space, the rental income therefrom will not be considered "rents" under this section. Here, "significant services" are those rendered primarily for the convenience of the tenant or occupant, and are other

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1 Sections 1371-1377 of I.R.C. See definition of "small business corporation" contained in Section 1371(a).

2 Rev. Rul. 60-183, I.R.B. 1960—19, 22 states that the time provided for the election under Section 1372 cannot be extended.

3 Section 1372(e)(5) of I.R.C.

4 Regulations 1.1372-4(b)(5)(iv).

5 Section 543(a)(7) of I.R.C.

6 Note 4, supra.

than those services usually rendered with the mere leasing of space. This provision will generally exclude the income received by hotels, motels, boarding houses or apartment houses furnishing hotel services, parking lots, etc. It is unlikely however that an apartment house corporation providing doorman and/or elevator operator service would escape the "taint" on its rent receipts.

It is interesting to note that the Congressional committee reports[7] explaining the reasons for the enactment of Subchapter S stated in part, "Your committee believes that the enactment of a provision of this type is desirable because it permits businesses to select the form of business organization desired, without the necessity of taking into account major differences in tax consequence." Obviously realty operating corporations were either not considered businesses by the Congress or were just discriminated against. A bill was introduced into the Congress[8] which would amend this inequity by applying to rents the same 50%-or-more test used for personal holding companies.[9] Those companies having rent receipts equal to 50% or more of their total gross income could elect the subchapter since such receipts would not be considered contaminated.

ADDITION OF UNTAINTED RECEIPTS

When rental property is held in corporate solution it might still be possible to qualify the corporation for Subchapter S treatment by the addition of "non-contaminating receipts." For example, an operating or manufacturing business might be added, the receipts from which would make Section 1372(e) inoperative. Further, since for some unknown reason, receipts from commodity transactions were not included in the proscribed receipts[10] (even though security transactions were so included), it would seem that if the corporation traded in commodities, in an amount sufficient to give rise to gross receipts (sales) in excess of 80% of its total receipts, the desired result could be achieved. The result would be the same even if a loss was incurred on the commodity transactions, since for purposes of Section 1372(e) receipts and not income is the measuring stick.

REMOVAL OF RENTAL PROPERTY FROM CORPORATION

Conversely, it may be desirable for the taxpayer to remove rental property owned by an operating or manufacturing corporation from the corporation where the rent receipts therefrom exceed the permissible minimum. In such a case he might resort to (a) a partial liquidation under Section 346, or to (b) a spin-off as provided under Section 355, or to (c) a redemption under Section 302. In each case, of course, the taxpayer must be certain to meet the requirements of the particular section chosen.

CONSTRUCTION

Subchapter S will generally be available to a corporation during the period of construction of rental property. Normally, during such period, the corporation would not be collecting rents [11] and therefore, if it meets the tests of Section 1371 (a), it could pass through to its shareholders the losses[12]

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[7] Senate Finance Committee Report Number 1983, dated August 12, 1958.

[8] H.R. 9207, 86th Congress, 1st Session.

[9] Note 5, supra.

[10] Section 1372(e)(5), although labeled "Personal holding company income," differs in many respects from the Personal Holding Company definition of Section 543(a).

[11] The receipt of prepaid rents during construction may cause a termination of the election. Accordingly, the use of an escrow agent or a security deposit classification should be considered as possible ways to avoid such terminations.

[12] Section 1374(b) of I.R.C.

from carrying charges, such as mortgage interest, building loan interest, real estate taxes, and other deductions customarily incurred during construction. By the use of a Subchapter S election the shareholders will immediately receive the benefits of these losses.

There is a limitation, however, on the amount of loss that can be deducted by the shareholders of an electing corporation.[13] Although the total loss is passed through from the corporation, the shareholder cannot deduct more than the amount of his investment in the corporation. (For purposes of this provision his investment (basis) includes moneys advanced by him to the corporation for stock and loans.) Losses in excess of basis are lost forever since the shareholder can't carry such excess backward or forward; and because the corporation passes its losses through, in Subchapter S years, it has no carryback or carryforward either.

As the year-end approaches, corporate records should be examined to estimate how much of a loss will be incurred. If the indicated loss is in excess of their bases, the shareholders might lend funds to the corporation, increasing their bases, and thus be able to take advantage of the full amount of the loss. These loans, to accomplish their purposes, must be "real" and therefore should not be immediately repaid; such repayment would probably cast the loans as mere exchanges and not additions to basis.

Other real estate and construction corporations, such as general or subcontractors, real estate or mortgage brokers, one-family house building corporations, landowners and developers and the like that meet the "small business corporation" requirements of Section 1371(a) can successfully elect to be tax-option corporations since their receipts are not of the proscribed nature.

SALE OF REAL PROPERTY

A sale of rental property, held for more than six months, is treated normally as the sale of property used in trade or business.[14] Gains realized on such sales are reportable as long-term capital gain, while losses give rise to ordinary loss treatment. It follows, therefore, since capital gains realized by an electing corporation are passed through to its shareholders as such,[15] the sale of rental property by an electing corporation will create a single capital gains tax at the shareholder level.[16] It should be noted however that the amount of long-term capital gain reportable by a shareholder of an electing corporation cannot exceed his share of the corporation's taxable income for the year.[17]

For the corporation owning rental income property to be eligible for Subchapter S treatment, in the year of the sale, the proceeds of the sale must equal more than 80% of the total receipts of the year.[18] This provision puts a premium on timing the sale properly. For example, the earlier in the tax year that title is passed to the purchaser, the less rental income will have been received by the corporation and the easier it will be to meet the 80% receipts test. If it is impossible to conclude the sale at a time during

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[13] Section 1374(c)(2) of I.R.C.

[14] Section 1231(b) of I.R.C.

[15] Section 1375(a) of I.R.C.

[16] Net gains on sales of Section 1231(b) assets are passed through to the shareholders as long-term capital gains under Section 1375; there is no requirement that they be offset against Section 1231(b) losses incurred directly by the shareholders. Section 1231(b) net losses of the corporation lose their identity in the pass-through to the stockholders. There is no requirement for the stockholders to offset corporate Section 1231(b) losses passed through against personal Section 1231(b) gains.

[17] Section 1375(a)(1) of I.R.C.

[18] Note 3, supra.

the tax year which would make a Subchapter S election possible, an effort should be made to arrange the terms of sale so that in the year of sale little cash is received and therefore, under the installment method of reporting,[19] only a small part of the profit will be subject to corporate tax in that year. In succeeding years, when the collections of the sales proceeds will be received, the Subchapter S election can be made and the bulk of the profits passed through to the shareholders, without the corporate tax burden.

RECEIPTS

What are receipts, on real property sales, for Section 1372 purposes? The regulations[20] give only a mercantile type of definition of the term "gross receipts," namely the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income, with no weight given to sales returns and allowances, cost of goods sold, or any other deductions.

Where the sale proceeds are all cash, there is no doubt but that the total sales price is the amount of the receipts. However, a realty sale for "all cash" is unusual. In the more customary transaction the seller receives cash, a purchase money mortgage, and/or conveys the property subject to one or more existing mortgages. In such situations the cash is treated as a receipt at the time of sale. The purchase money mortgage is treated as a receipt, as collected, except in those instances where the taxpayer elects the provisions of the deferred sale method, in which case he would report the fair market value of the purchase money mortgage as a receipt at the time of the sale. The problem of existing mortgages that are transferred with the property is covered later in this paper.

INSTALLMENT SALES UNDER SUBCHAPTER S

An effort is also usually made to meet the 30% test of the installment sale provision[21] to enable the taxpayer to report his gain on the sale as he collects the proceeds. Under Subchapter S, since the property is sold and the gain reported by the corporation (even though it is passed through to the shareholders for taxation purposes), the installment method of reporting the gain will be available to the shareholders providing that the corporation elects the installment method on its return. This beneficial treatment is to be contrasted with a corporate sale under a Section 337 liquidation where the installment method would be available because of the terms. In the latter situation, even though the corporation is also the seller, since the gain to the shareholders is not on the sale of the property but occurs on the liquidation of the corporation, the installment method of reporting the gain on the sale may not be used by the shareholders.

COMPUTATION OF RECEIPTS ON INSTALLMENT SALE

Prior to the issuance of the regulations covering Subchapter S,[22] varying opinions were express concerning the proper method of computing receipts, under the subchapter, on a realty installment sale. The regulations haven't made the answer exactly crystal clear. They cite an example[23] of receipts under an installment sale of *personal* property, but remain silent as to real property. In the example shown in the

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19 Section 453(b) of I.R.C.

20 Regulations 1.1372-4(b)(5)(ii).

21 Note 19, supra.

22 The regulations covering Sections 1371-1377 were issued in proposed form on March 12, 1959 and finally adopted December 18, 1959. T.D. 6432.

23 Regulations 1.1372-4(b)(5)(ii), example 3.

regulations, only installment payments actually received in the taxable year are considered as receipts.

It is recommended that the taxpayer take the position that he has been paid the amount of existing mortgages transferred to the purchaser at the time of sale. Under this theory he could then include such amounts as receipts in the year of sale for purposes of Section 1372. If such a determination is not made, and the regulations are followed literally, these amounts will never be included as sales receipts.

After making the determination as to the amount of receipts on the sale in order to qualify under Subchapter S, the taxpayer must be alert to the effect on the election of the receipt of interest due on the purchase money mortgage (which came into existence on the sale). Will this interest be more than 20% of the receipts of the corporation in future years, causing it to lose the election and thereby making the profit not yet reported on the installment sale subject to the corporate tax? Perhaps the problem can be obviated by including the value of the interest to be collected in the sales price, by providing a corresponding increase in the principal amount of the purchase money mortgage.

RECEIPTS UNDER LONG-TERM CONSTRUCTION CONTRACTS

The regulations[24] also point out that a corporation that has a long-term contract on which it is reporting the income under the percentage-of-completion method,[25] will include as receipts for purposes of the subchapter, that percentage of the total contract price which corresponds to the percentage of completion for the year. It therefore follows that a corporation which reports under the completed-contract method[26] will only have Subchapter S receipts in the year of completion of its work under the contract. The corporation must therefore be certain as to what will constitute completion for purposes of such reporting to insure having the receipts reportable in the proper year.[27]

CAPITAL GAINS VS. COLLAPSIBILITY

As Congress enacted the law, a qualifying electing corporation that has a capital gain passes this gain through to the shareholders[28] without regard for the provisions of Section 341,[29] a seemingly tremendous loophole. The Code does not discuss or reconcile in any way the possible inconsistency of the collapsible corporation provisions with Sections 1371-1377. Certainly the Congress was well aware of collapsible corporations and their problems at the time of the enactment of the subchapter as can readily be seen from the simultaneous enactment of Section 341(e).[30] A thorough reading of Sections 1371-1377, however, will not disclose a single reference to collapsibility.

The Internal Revenue Service, in its proposed and final regulations covering Section 1375, has in effect tried to legislate a provision to close this loophole. The regulations[31] take the position that normally the determination of whether a sale by a corporation gives rise to capital gain or ordinary income to the corporation is decided

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24 Regulations 1.1372-4(b)(5)(ii), example 2.

25 Regulations 1.451-3(b)(1).

26 Regulations 1.451-3(b)(2).

27 Standard Paving Co., et al., 13TC 423 Aff'd (C-10), 190 F 2d 330; N. Wohlfeld 17 TCM 677.

28 See discussion under "Sale of Real Property," supra.

29 Section 341 of I.R.C. of 1954 covers collapsible corporations.

30 Section 341(e) is a relief provision designed to alleviate some inequities under Section 341.

31 Regulations 1.1375-1(d).

at the corporate level. However, if a shareholder (or a group of shareholders) owns a "substantial portion of the stock" of a Subchapter S corporation, and the corporation sells property, which would not be a capital asset in the hands of the shareholder, then on such a corporate sale the gain will not be considered a capital gain to the corporation.

For the second time in recent tax history we have an imputation of status,[32] the taint of a shareholder coloring a corporate transaction. The Commissioner also included in the regulations, in determining a stockholder's status, the activities of other electing small business corporations in which the stockholder owns an interest. And although this portion of the regulations is completely without statutory foundation, its purpose and use as a deterrent will undoubtedly be successful. Also the usual problems will arise in trying to interpret the regulations to determine what a "substantial portion of stock" is; what a "group of shareholders" consists of; whether the corporation "was availed of . . ."; and on those borderline cases where the shareholder is not an out-and-out realty dealer, what type of gain would he have realized had he made the sale—capital or ordinary?

SALE OF STOCK

If in lieu of permitting the Subchapter S corporation to sell its assets (with the shareholders receiving their gain on the "pass-through") the taxpayers realize their gain by the sale of their stock or by liquidating the corporation, the results to them could be substantially different. Section 1372(b)(1) provides that a Subchapter S corporation ". . . shall not be subject to the taxes imposed by the chapter." The Subchapter S corporation is thereby relieved from paying income taxes, personal holding company taxes and surplus accumulation taxes. In all other respects, however, including being subject to the collapsibility rules, a tax-option corporation is treated as any other domestic corporation.[33] It would therefore follow that the gain to a shareholder on the sale of stock of an electing corporation that falls under the provisions of Section 341 would be an ordinary gain—the Subchapter S election provides no insulation against collapsibility on such stock sales or liquidations. However, had the stockholders framed the transactions as a sale by the corporation of its property, the collapsible rules would not apply and on the "pass-through" they would have capital gains to report instead of ordinary income, assuming the corporate sale was one that came under Section 1231.[34]

COLLAPSIBLE CORPORATION TESTS

Some interesting questions arise in the interplay of Subchapter S and collapsible corporations. Assume that a Subchapter S corporation owned a large tract of land for two years and then sold ¾ of the tract, realizing ¾ of the total profit to be realized on the sale of the whole tract. It would appear that even though the corporation pays no tax on the profit from this sale because of its Subchapter S election, for purposes of Section 341(b) the substantial realization test[35] has been met and the corporation is not collapsible. However, in another situation where a corporation

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32 Note 30, supra.

33 Regulations 1.1372-1(c).

34 It is possible that non-dealers would receive capital gain on the sale of their stock if they met the tests of Section 341(e) .

35 Although the Internal Revenue Service has never published their position on what percentage is necessary for "substantial realization," it has been felt (based upon unpublished rulings) that 50% would be sufficient. The Tax Court in Kelley 32 TC 135 approved 33-1/3%.

also sells its property yet pays no tax on any gain therefrom, the Commissioner has ruled differently.[36] Reference is being made to sales by a corporation in the process of a complete liquidation under the provisions of Section 337. In this situation the corporation is selling its assets as an agent of the stockholders and as such, under the special relief provisions of Section 337, is not considered to have realized any gain on such sales and therefore does not receive credit towards meeting the substantial realization test of Section 341.

What would the tax result be if an electing corporation, owning two separate properties, sold one at a gain and thereafter the shareholder sold his stock of the corporation at a stepped-up price to realize the profit on the unsold parcel? It would appear that he would be trapped by Section 341 since even though there is complete realization on the property sold by the corporation, there is no realization on the unsold piece and so the substantial realization test has not been met. Further, for purposes of applying the 70-30 limitation,[37] an examination must be made of the sources (collapsible and/or non-collapsible) of the shareholder's gain on the sale or liquidation. In the above case the shareholder's basis for his stock was increased by the amount of the gain passed through to him on the sale of the one property by the corporation. Thus for tax purposes the entire gain on the disposition of his stock would be from the appreciation of the remaining unsold collapsible property. The shareholder therefore would not meet the requirements of the 70-30 limitation either.

It appears, however, that a real estate dealer can still get capital gains treatment on Subchapter S corporation transactions, in spite of the regulations, if he sells his stock in the corporation more than three years after the completion of construction of the property or is able to avail himself of any of the other statutory outs under Section 341. However, if he were to cause an electing corporation to sell its property, even after the three-year period has run, it would appear that he would get ordinary income treatment as provided in the regulations covering Section 1375. Dealer beware!

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[36] Rev. Ruling 58-241, 1958-1 CB 179.
[37] Section 341(d)(2).

Function of the Traditional Accounting System

The traditional accounting system was devised to account for the money values. This was natural and most convenient in the past, because fluctuations in the value of money were little known as the prices of goods and services were generally determined by custom and economic forces. The legal system, covering the commercial transactions, recognized the money values for enforcing payments of debts and tax liability. Now, under changed economic conditions, the principles and technique of accounting used are inadequate to meet the needs of business for correct information which is free from distortion in values caused by inflation. This is a challenge to accountancy to develop itself to fulfill its purpose as a "tool of management."

The Chartered Accountant, May 1961, p. 416

Advantages of Statistical Sampling Techniques in Physical Inventory Counts, and Conditions for Their Use

By JOHN RAPP, CPA

Because inventory taking and checking are amongst the most burdensome and most challenging problems for managements and accountants, anything that offers substantial relief is worthy of careful consideration. Statistical sampling techniques offer some relief. Without exhaustive treatment, the author creates an awareness of the possibilities for economy without risk of loss of reliability.

POTENTIAL BENEFITS FROM THE APPLICATION OF SAMPLING TECHNIQUES

Direct Benefits to Management: Management's interest in inventories centers on maintaining available for customers sufficient quantities in the required proportions consistent with minimum freezing of capital. To achieve that aim, requires good accountability and control at the lowest possible expense.

Management can be aided in the desired direction by an inventory control program calling for relatively frequent physical test checks on high unit cost items, decreasing in frequency as the unit cost goes down, provided that the factors of significance in relation to total inventories, portability and direct consumer interest are taken into account. Such an inventory control program would appear to be practical, with increased chances of uncovering benefits at little or no extra cost, sometimes possible at a reduction in cost, by reason of more selective application of control procedures. Benefits primarily considered here are those resulting from the more frequent availability of either more reliable inventory data, or data whose margins of error can be determined within ascertainable limits. As a result, management may have a better opportunity through timely use of better inventory data, to reduce imbalance of production or marketing efforts and to correct waste and inefficiency in either direction.

Ascertainment of inventory quantities by count, weight or measurement, often a laborious and expensive task, can be made less time-consuming and costly in appropriate cases by the use of statistical sampling techniques. However, where sampling techniques are used, it is necessary to take many precautions because there are many pitfalls for the unwary.

It is the purpose of the following discussion to stimulate thought and investigation in areas of inventory man-

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agement and control, to point out wherein sampling, in various forms, can be useful, and to indicate the conditions that are necessary to assure reasonably accurate overall results from tests.

When inventory items to be counted, weighed or measured are both relatively large and readily identifiable, a full count presents few problems, as for instance in the case of a car dealer. When bulk materials, small manufactured parts or assemblies, or large quantities of packaged or unpackaged finished articles are involved, quantity ascertainment generally regarded as "complete" may, in fact, be incomplete. Satisfactory coverage rests on certain assumptions and is subject to limitations later described.

THE USE OF SAMPLING TECHNIQUES

In Large Organizations: In a large organization using perpetual inventory records and taking advantage of punched card equipment the use of statistical sampling techniques can bring about considerable savings as compared with traditional methods of quantity ascertainment, involving complete counting, weighing and measuring of unpackaged items and counting of full containers for packaged items. For a fascinating case study illustrating the application of statistical sampling methods through a step-by-step description of the work performed, the reader is referred to the March 1958 issue of "The Journal of Accountancy," page 53 through 59, in which Raymond F. Obrock, controller of Esso Research and Engineering Company, deals clearly and forcefully with his company's experience in one area of its operations as regards 1956 closing inventories. Application of statistical sampling techniques to supply inventory counts brought about time savings of over 50% as compared with the time required for corresponding full counts. The techniques used involved the drawing of a random sample, stratified to give greater emphasis to items considered sensitive because of relatively high unit cost or risk of loss through pilferage; a physical count of the items called for by the sample, and a computation of the dollar adjustments required in respect of such items. By reason of elimination of overtime the related expense saving was relatively even greater than the significant time saving previously mentioned. Furthermore, after the sample count results had been used for adjustment of perpetual inventory balances, the adjustments were averaged for each stratum and the resulting averages projected to estimate, within close confidence limits, the overall net inventory adjustment required. The projected adjustment was in line with experience in prior years based on complete counts, and the upper and lower limits, within which the projected net adjustment could vary as a result of calculable sampling errors, were reasonable enough to provide corroboration of the adequacy of the sample.

In Smaller Organizations: From the case study mentioned, the inference may be drawn that similar opportunities for savings are likely to exist in other companies similarly placed as to inventory diversification and inventory records. But the uses of sampling techniques as an aid in inventory management and control are not limited to applications in large organizations using punched card or similar data processing equipment. Sampling techniques can be applied to inventory counts whenever there are perpetual inventory records, and under certain conditions even when there are no formal records of that nature.

FORM AND RELIABILITY OF SAMPLING

A sampling is a partial count, weight

or other measurement technique, so conceived as to be sufficiently reliable to determine total quantities with reasonable correctness. In some cases, sampling is virtually mandatory, as in the case of bulk materials, such as coal or other materials in piles, grain in elevators, or bulk liquids in tanks, where a full count would be impracticable because of the composition, form or storage of the materials. In other instances, sampling techniques may also be virtually mandatory because of the substantial time and cost reductions they make possible.

A sampling must be carefully conceived, otherwise its deficiencies and inaccuracies are multiplied many times. However, there has been sufficient experience with sampling techniques to assure managements and accountants that the proper use of carefully planned techniques can provide reliable results. To insure that any item in a "universe" is as likely as any other to be selected for inclusion in the sample, tables of random numbers prepared by skilled statisticians are used, as was done in the Esso case study previously mentioned. The size of the sample will determine the degree of reliability to be expected. Therefore, when it is desired to obtain results within very close tolerances the sample has to be larger than it would have to be under less stringent requirements. That requirement was met in the Esso case study by "stratification," in that for high unit cost and other sensitive items the sample represented a larger proportion of the universe than was the case for less sensitive items. As the risks of error and the related confidence limits depend on sample size, it is possible to design samples meeting requirements of well-informed judgment of the surrounding conditions, and to obtain at least a range of possible answers to the perennial question "how much testing is enough?" which has particular significance in the context of physical inventory counts.

PITFALLS IN SAMPLING

Solid Bulk Materials: In estimating quantities of solid bulk materials it is generally assumed that the invisible major portion corresponds reasonably well to the visible outer portion as to size, quality and usability. The assumption may be well founded where material is of uniform consistency and slow to deteriorate, as in the case of ores of a particular grade, but may be less than justified in the case of a coal pile. The inside of such a pile is sheltered from outside heat, cold and humidity, but, on the other hand, it is subject to great pressure. Some of the coal inside may be ground to dust and turn out to be less than fully usable. Materials such as flour and cement, usually protected from the full impact of the elements, absorb moisture from the outside and tend to deteriorate from the exposed surface inwards. Sand on a building site, in spite of the outside part of a pile being exposed to weather, may contain more moisture on the inside of the pile from which evaporation cannot take place. Materials such as piles of metal scrap at steel mills and other metal processing plants generally lack homogeneity to such a degree that anything but the most conservative estimating may be useless and dangerous.

The generally applied practice of drawing samples from different parts of the outside of an apparently homogeneous solid bulk material pile, to establish the weight of the contents of a container with known dimensions, (on the basis of which the total weight of the pile is calculated once its cubic content is known) fails to take sufficient account of variations due to temperature, pressure, humidity and other possible sources of deterioration. In some cases, the very weight of an outdoor pile of bulk material causes sag-

ging of the ground below, unknown until the pile is exhausted. Serious errors in quantity ascertainment can occur, unless storage conditions are well controlled and the results of calculations based on samples available—which cannot be truly representative—are adjusted by reasonable experience factors.

Individually Inexpensive Small Parts: While in many situations quantity ascertainment by weighing such parts gives sufficiently accurate results, this is not likely when the parts are of a special nature and represent a large portion of the maker's production and inventory. In such a case, a reasonable solution is "counting by weighing," through the use of ratio scales. (1,000 to 1,100 to 1, 10 to 1; and, 999 to 1, 99 to 1, 9 to 1 are two types commonly used.) A count by use of ratio scales is satisfactory only where "samples" in the scales correspond exactly or very closely wtih the "universe" on the platform. This is likely to be true in the case of machined parts manufactured to very close tolerances, and is more reliable for parts having passed substantially all phases of production and inspection than for parts in the early stages of the production cycle. Since the parts, at the time of passing over the ratio scales, are contained in bins or drums and since it is not always possible to use receptacles of a standard weight throughout a physical inventory count, care must be taken to adjust the scales each time the tare varies.

Articles Packed in Shipping Cartons: Packaged finished articles are often stored on pallets in closed shipping cartons, and a count of pallets alone, full and partly full, is regarded as a count of the enclosed articles. A count thus conducted is based on two assumptions: the first is that all shipping cartons are full, and the second is that all of them contain the articles called for by the description on the outside of the cartons. Individual shipping cartons would be counted on partly full pallets. Test counts of cartons picked at random are made to justify the assumptions used; in practice, such test counts are made by an observer rather than by the person responsible for the initial quantity determination.

For a visual count of this kind to be reliable, it must be assumed that the packing of articles and stacking of cartons are so fully mechanized and so closely supervised that accidental or deliberate removal or substitution of full cartons or individual articles can be practically ruled out. Since such an assumption woud be unrealistic, persons counting such items try to cover themselves by opening shipping cartons "on a test basis." But while a small test of unspecified proportions may give subjective benefit in terms of calming the vaguely uneasy feeling of a person counting shipping cartons, through showing that some of them have some content, the objective result of the test would be much less reassuring. For it would mean that there is a residual chance, depending on the extent of the test, that certain shipping cartons have either no content or the wrong content; and as to number and correctness of finished articles in each carton, the test, unless extended, would have even more limited results. In the situation described, the desired level of reassurance could be obtained only by more extensive and selective test checks.

Unpackaged Finished Articles: Unpackaged finished articles, whether sold in such manner or held thus for later packaging, cause inventory control problems when held in quantities too large to make full counts practicable. Cigars, for instance, may be stored in standard-size trays with open fronts that permit unit count. But a

count of items, based on a count of the number of trays with "test counts" of units in individual trays, will give a reliable result only if the capacity of the trays is uniform and fully used, the spacing of units is uniformly as tight as possible, and the physical dimensions of units are uniform. Manufacturing controls provide assurance as to the last-mentioned requirement, but not as to the others. Thus it is possible for quantities of production or inventory, reported as accurate on the basis of accepted count practices, to differ appreciably from the actual quantities. For where there is a material lack of uniformity, sampling techniques, however well conceived, will result in a count that will contain a serious element of error.

PROBLEMS OF PERPETUAL INVENTORY RECORDS

The usefulness of sampling techniques is not limited to volume counts of large numbers of inventory items as of one particular date. Quantity determinations are the foundation of all inventory accounting, seen directly in periodic physical counts and indirectly in the data contained in perpetual inventory records. The reliability of perpetual inventories can be improved by statistical sampling of goods received and issued.

Broadly, the debits to such records come from inbound shipments and transfers from earlier stages of production, and the credits come from transfers to later stages of production and outbound shipments. Balances in perpetual inventory records cannot be more reliable than the related basic information. Receipts and withdrawals for use require quantity ascertainment before recording is possible.

Receipts from outside sources are generally documented by receiving reports. If such reports can be prepared from suppliers' shipping documents showing quantities, there is great temptation to transcribe quantities reported by the supplier, particularly at times of pressure on the receiving department, no matter whether company rules prohibit such a practice. In that situation, the reliability of recorded receipts depends on that of the suppliers' shipments, generally an unknown factor except in a very broad sense. Only when receiving reports are completed on the basis of independent count, weight or measurement can statistical sampling techniques be called upon to provide help.

When packaged finished goods are received in shipping cartons, it is rare for receiving department personnel to go beyond ascertaining the number of shipping cartons, unless some or all of them require immediate unpacking, which is unlikely except in a small operation and certain special situations. The related debits to perpetual inventory records would be made reliable, within certain confidence limits, by sufficient tests of shipping cartons selected at random by opening them and inspecting and counting the contents. On the other hand, receiving department personnel may, in compliance with instructions, weigh every bundle of aluminum sheets or steel bars when time and expense could be saved, without significant loss in reliability of information, by sufficient test weighing. The acceptability of various risks of error and related confidence limits depends on the unit cost, portability and certain other characteristics of the items studied. In general, items of relatively high unit cost, items of high direct consumer interest and items easily portable should be subjected to more extensive and intensive testing than those items which do not possess the characteristics mentioned to a similar degree.

Debits to perpetual inventory records originating from internal production records are generally predicated

on appropriate count, weight or measurement at the end of the latest preceding phase of production. In order to overcome certain shortcomings inherent in the generally used methods of quantity ascertainment, all available mechanical and other technical means should be used to facilitate determination of the content of a reasonably small storage unit by reference to which work can proceed through count, ratio scale weighing and other appropriate means.

Credits to perpetual inventory records to reflect internal transfers should be similarly supported. While the use of statistical sampling methods may not be readily apparent in this context, the very method of proceeding from "sample" to "universe" is a statistical technique, and the results to be expected therefrom will depend in reliability on the care applied to the sample, in this case the "reasonably small storage unit."

Withdrawals of finished articles for shipment to outsiders and the related quantity determinations can be expedited through adequate controls at various stages of manufacture or processing, and facilitated through proper warehousing techniques, including planned use of materials handling equipment. The related credits to perpetual inventory records are derived from shipping information purporting to be based on count, weight or measurement. The main problem appears to be the reliability of quantity information on packaged finished articles for which shipping department personnel tend to limit their work to counts of containers, taking for granted earlier quantity determinations in the course of packaging and production as the contents of the containers. Detailed test counts by shipping department personnel to establish reliability of contents within confidence limits considered acceptable would, at the price of some extra effort, help towards more accurate shipment records, fewer inventory differences, and possibly fewer customer complaints.

Adjusting Perpetual Inventory Balances: With a perpetual inventory record in use, adjustment of balances at the end of the fiscal year or other suitable dates to the results of physical inventory quantity determinations, necessary as it is, can be simplified and expedited when statistical sampling techniques are used in the quantity determinations. In part, this simplification may result from the probable reduction in the number of reasons for prima facie inventory differences; in part, too, it may come about through the highlighting of inventory areas in which the cost of using certain control techniques compares unfavorably with the benefits likely to be obtained by the use of such techniques. For instance, if adequate control is kept over low unit cost items through perpetual inventory records, prepared with the help of statistical sampling procedures all along the line, the likelihood of substantial discrepancies between physical quantities and book balances may be reduced to a degree which may be considered acceptable as a practical business matter, without the need to incur trouble and expense connected with a full inventory count.

PROBLEMS WHERE PERPETUAL INVENTORY RECORDS ARE NOT KEPT

Where perpetual inventory records are not in use, inventory management and control are altogether dependent on periodic physical counts. Such work when carried out once yearly at the time of fiscal closing may provide certain information for adjustment of accounts, but it does not, except in a very limited sense, help towards good inventory management or control. Frequent overall inventory counts are too

time-consuming and costly to merit consideration.

Stratification of Inventory Items: One method for taking inventory more frequently, without undue burden and cost, is the "stratification" of inventory items in terms of dollar cost per unit. Items above a certain unit cost would be subjected to frequent full counts, especially when total investment in them is significant. Other items would also be subjected, over a period, to more or less frequent item counts, giving within the period the assurance and control achieved through full counts at a particular time without causing corresponding expense. How can partial counts of inventory items, in the absence of related perpetual inventory records, permit inferences as to the "universes" from which the items are drawn? Only if they are typical of the "universes" in the sense that any item has the same chance of being drawn for the sample, i.e., the partial count, as any other item. Items with dissimilar characteristics would constitute different "universes" for this purpose. Should there be as many "universes" as there are product, component and material classifications? The general answer is affirmative.

Cycle Counts: When inventory items are more or less homogeneous in character in that unit costs are within a moderate range and there is little need for special control of high unit cost items, it may be practical to make counts on a cycle basis at reasonable intervals. Cycle counts might be used in a retail store handling budget dresses and related items.

The possible solutions mentioned are incomplete in that they provide merely for quantity determination without possibility of remedial action by determination of differences and their causes. In answering the question "what *do* we have?" they do not answer the equally important query "what *should* we have?" In order to make the rudiments of inventory control possible in the situations outlined, it would be necessary to build up, from an agreed starting point, a record of receipts and withdrawals for use.

It may be found, in situations similar to those contemplated here, that the very attempts at systematization mentioned may prompt establishment of the foundations of perpetual inventory records. However rudimentary they may be at the beginning, they will in time prove their usefulness as a management tool and thereafter be refined as required.

THE INDEPENDENT CPA'S HELP TO MANAGEMENT

In his usual audit tests directed to observation of physical inventories, the CPA in public practice does apply the policy of "accentuating the positive" by being selective in his work and attaching most importance to aggregate dollar value and product or component unit costs. In a non-homogeneous inventory, however, he cannot readily evaluate the risk of not detecting errors or misstatements in the inventory through incomplete observation on his part, unless his audit tests are based on statistical sampling procedures appropriate in the circumstances.

Where the client organization itself does not use such procedures for determining inventory quantities, it may be necessary for the CPA to set up "trial run" applications of the procedures, with the twofold objective of satisfying himself that the limits, within which the calculable sampling error is likely to be, are close enough for him to express an unqualified opinion with respect to inventory observation, and of demonstrating to the client that scientific sampling procedures are effective when used with proper precau-

tions. Such trial runs might involve determining quantities in reasonably homogeneous sections of the client's inventory first with the help of statistical sampling techniques, and thereafter making complete counts of the same items. The expense caused by extra time required by the CPA for the "trial runs" is likely to be offset by reduction in the total number of inventory observations required to achieve probably more effective coverage.

Where statistical sampling techniques are used for the data reflected in inventory records and also for physical observation (which, at this point, is taken to mean that at which he is represented), the CPA might well devote some of his effort to a review of the manner in which the client organization determines and applies statistical sampling techniques to "book" and "physical" inventories, and of the reasonableness or unreasonableness of the resulting practices with regard to inventories, such as extent and timing of physical counts. Depending on the outcome of such a review, some extra observation effort might be directed to particularly difficult areas, away from others better covered by the client's own "searchlights." The use of sampling techniques to measure the efficacy of the client's application of sampling techniques to year-end inventories may well help bring about a sufficient decrease in the volume of year-end audit work on inventories to make possible earlier completion of the year-end report for issue to the client.

In so far as the CPA in public practice renders management advisory services, concurrently with, or apart from the audit function, he is primarily concerned with giving to management serviceable accounting tools for decision-making. In that context, he should explain to management the possibilities inherent in a judicious use of statistical sampling techniques in any areas in which they may be of use, without limitation to the area of inventories. He might, however, stress that a study of the techniques for application to the inventory field is likely to produce measurable direct and indirect benefits, the latter coming about mainly from a systematic and critical weighing and reevaluation of existing control procedures. THE END

Need For Self-Realization

Self-realization is the ultimate in the hierarchy of needs. In the language of philosophy, it entails the fulfillment of one's highest potential. It refers to doing or being what one can do or be; it requires making use of all one has, to become everything that one is capable of becoming.

As human potentials vary from individual to individual, so must self-realization. Advancing nuclear theory, writing poetry, playing golf, managing an enterprise, or being an ideal mother can all be expressions of self-realization. The one characteristic underlying all these activities is fulfillment of capacity, whether that capacity is large or small.

Charles D. Mc Dermid, "How Money Motivates Men,"
Business Horizons, Winter 1960, p. 96

Considerations in Entering the Export Field

By ROBERT H. KULKA

The export trade is somewhat of a mystery to those who have not explored it. Inasmuch as it is an increasingly important economic and political goal for our country, an insight into its ramifications should be of interest to accountants.

The alerting of the American public by the government to the necessity to increase export trade is timely. Not only can it help to stem the outflow of gold and increase employment, but it can also act as a spur to manufacturers who are already exporting, to investigate and research the adequacy of their present export operations for the possibilities of augmenting volume. To those manufacturers who have at present only a domestic market, it is not only a call to investigate, but if their merchandise is suitable for the export market, to start developing foreign trade before competition makes it too late.

Accountants can play an important role in increasing American participation in world trade. As advisers to clients, they can point out the existence of markets in overseas countries that are growing at high annual rates. There presently are ninety foreign markets that have possibilities for American businessmen. Accountants may also be asked for their views on the desirability of entering the foreign field, the steps that must be taken, and the financial aspects of such operations. For these reasons it is well for accountants to have a knowledge of certain basic aspects of foreign trade—not as experts of course, but enough to know what the company should and should not do initially.

It is the purpose of this article to furnish accountants a broad picture of the initial research required, the organization of such an export operation and its financing, independent specialist aid available here and abroad, credit and collection problems and many other aspects. This should provide a reasonable basis for the initial considerations in entering the export market.

Foreign trade is not a monopoly of big business, though to many smaller manufacturers it may appear to be so. Actually there are many relatively small companies, who directly or in-

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This article has been adapted by the author from a paper presented by him at a meeting held on May 17, 1961, sponsored by our Society's Committee on Foreign Trade Accounting.

directly are participating in international trade. Nevertheless, there are a great many more relatively small companies that are losing sales and profits, and are not contributing to the upbuilding of our economy through larger world trade. There are a number of reasons for this failure, some not flattering, such as unawareness of the existence of outside markets, misconceptions, undue fears and puzzlement as to how go about it.

The Federal government in its urgent efforts to increase foreign trade provides facilities to encourage it. Its program includes aid in financing foreign trade, guarantees against losses in foreign credits and foreign exchange hazards, and also extensive information about foreign markets and other helpful information.

INITIAL INQUIRY

Say, for instance, your client manufactures plastic raincoats and wishes to enter the export market—how should he approach the problem? First, he should get a good atlas and get an up-to-date view of the world. Also, he should learn where the 90 markets are which I specify as being worthy of consideration.

Second, he should pick out a dozen or so markets to start with and decide that he will investigate them, as to the practical possibilities for the use of his product. What he must determine are (a) whether the article is needed there (b) whether the quality is acceptable (c) what competition he has to face from overseas competitors (d) is something similar made locally (e) what is the duty on his article and the landed cost (f) what such articles sell for locally and what margin there is for the importer and retailer (g) what margins are necessary (h) what were the imports of raincoats during the last 3 years (i) should he sell to one firm only and give them an exclusive franchise, or sell to several importers (j) what credit terms are suitable (k) what sort of packaging and export packing is necessary. The foregoing points are commonly the main considerations of a preliminary survey, to determine whether the markets offer a prospect of successful business.

HOW AND WHERE TO GET INFORMATION

There are various ways of securing the foregoing information: apply (1) to the consulates here of the selected countries (2) to the Department of Foreign Commerce in Washington (3) to banks that have local correspondents abroad (4) consult an export consultant.

ROLE OF AN EXPORT CONSULTANT

An export consultant will undertake an assignment on a contract basis, with fixed remuneration, to make a complete investigation. He will also undertake to act as consultant, if later required, on a per diem basis. Expert and experienced consultants are paid approximately the same fees as are paid domestic management consultants. Fees average \$250 per day for very short term assignments, \$150 per day for assignments up to about twenty days, and less for monthly assignments. Experience dictates that in the engagement of an export consultant, as in other professional selections, it is cheaper in the long run to get the best advice.

ROLE OF A COMBINATION EXPORT MANAGER

The combination export manager usually enters the picture after the consultant has done his job to handle all of the ramifications of establishing an export department. Any such arrangement generally is on a yearly basis as a manager usually insists on a reasonable period of continuity, if he

is to expend his time and effort successfully in opening up overseas markets. The first year or two usually are the most difficult until the project really gets under way. One must expect that it will require about eight to ten months to get properly started and perhaps get the first shipment into the customers warehouse overseas. The time schedule is not the same as in the USA where merchandise is shipped and received within a few days. Overseas shipments by freight sometimes take three months before reaching their destination, as in markets like Burma or India. It all depends of course on whether the merchandise can be shipped by air or not. Big advances are being made by air lines to furnish better service overseas at competitive rates. This may hasten the evolution of the business in certain areas, but it is safer to figure on the eight to ten months period for getting started.

The financial arrangement with the manager depends upon the probable volume to be expected, and also on the world reputation of the manufacturer. If his merchandise is really quickly saleable, and it is not necessary to introduce a new brand name article, the manager may be willing to work on a fixed percentage of sales of about 10 to 15%. In many cases the manager also receives a fixed fee for travel, entertaining and other expenses. Such a fee ranges between $2500 to $5000 yearly.

OWN EXPORT DEPARTMENT

The manufacturer, however, may decide after evaluating the replies from the first overseas investigation, if they indicate that a satisfactory business could be developed, that he open up his own export department. This must be a distinctly separate department and not one run under the aegis of the domestic sales manager. So many U.S. concerns try to combine the export sales with the domestic, not realizing the special problems and concepts which have to be considered in overseas transactions. What is needed is an experienced export manager, who knows several languages, shipping and export procedures, and financial practices.

Departmental Budget. A budget should be set up for the department covering advertising, entertaining and travelling expenses. A competent, experienced export manager will require anywhere between $15,000 to $30,000 yearly in salary; dependent on his background and experience, and the potentialities inherent in the overseas sales. To start with the staff could consist of the export manager, and a bilingual secretary with a salary of about $125 per week. Air-mail postage may run up to $50 monthly for correspondence, apart from cable and telephone expenses. If samples are to be distributed, their cost must also be reckoned with. Provision should also be made for the cost of translation and printing of circulars and literature in various languages. The foregoing covers the basic costs of operation, at least for the first eight months.

Travel Expense and Time Requirements. Only after the preliminary ground-work has been established need any overseas travel be considered. Outside of the fares, the average daily expenses of a traveller overseas amount to between $40 and $50 daily. This varies according to the areas of the world covered. It must be realized that visits to overseas markets cannot be made at the customary rapid pace of travel as in the United States. One has to face unusual conditions in each country, such as many religious and national holidays.

OVERSEAS DISTRIBUTION CHANNELS

Dependent on the type of merchandise, the manufacturer may arrange in each overseas country for an exclusive distributor, by contract for a period of from 1 to 5 years, renewable by mutual consent. The advantage of having an exclusive distributor in any market is that it is customary to obtain from him a certain annual minimum guarantee of purchases. Furthermore, with only one customer in the market with whom to deal, it is easier to handle such matters as advertising, sales promotion, etc.

If the merchandise is such that it can be sold to many importers, then a local commission agent should be employed in each country. Such an agent works on a fixed commission of from 5-10%. He just books orders and sends them on to the manufacturer to execute.

CREDITS AND COLLECTIONS

This is an important subject for consideration. The good old days of letters of credit with the order are now numbered. In a few countries, except in the Far East, they are used only for large transactions. There are other ways, however, to insure export shipments, such as through the Import & Export Bank in Washington. This bank covers political risks in case of a sudden change of government which might affect payments. Our government guarantees are slowly evolving, so as to compete effectively with similar government aid by European countries. In dealing with first class concerns overseas, many of whom have been established for over a hundred years, who operate all over the world, and on whom you can get banking and other credit references, you are quite safe in selling them on terms of 60 day draft attached to shipping documents. The customer has to sign the draft before the bank releases the shipping documents to him.

On the other hand, much business is done on the basis of cash against documents. It all depends on the country, the customer, and the type of merchandise. One cannot generalize on this point. For fuller details as to financial terms, it is suggested that the manufacturer consult a specialist in this field who keeps abreast of changes, from day to day in the Import & Export Bank actions. The export consultant or the export manager can also assist with this investigation.

SHIPPING REQUIREMENT

Freight shipments abroad should usually be packed in wooden export cases, waterproofed if necessary. The cost of these is added on the invoice. The use of specialized export packers, should be checked, because foreign import requirements are different from country to country. For instance, some countries charge duty on the gross weight, including packing cases, so that the matter of the type of packing is one that must be carefully studied and taken into consideration.

MANUFACTURING ABROAD

The question of manufacturing abroad under license may arise. To go into this matter thoroughly would entail a lengthy article by itself. Here are some of the highlights of the advantages, risks and pitfalls which must be faced. Should the product be a chemical, plastic or perfumery item, it is conceivable that manufacturing overseas on a royalty or license basis may be advantageous in large markets, such as India, Australia, Argentine, Great Britain and Brazil. It is, of course, necessary to have first class associates overseas who are well recommended by local banks. If the manufacturing is to be done on a royalty basis, it is advisable to fix a

minimum yearly guarantee of such royalty. If a profit sharing basis is desired, then, in today's world, it is advisable to have local partners on a 50-50 basis. I say this because today foreign nations look upon incoming capital, differently than 25 years ago. Today they think that a foreigner should consider it a privilege to be allowed to invest in their country, especially since the average net profit is usually a minimum of 15-20%. Agreement terms will vary according to the country and merchandise, but it is not possible to go into details in this article. Well recommended foreign lawyers, and a U. S. consultant or expert well versed in this type of operation usually should be consulted in such deliberations.

Many countries today are eagerly offering full guarantees for the repatriation, in dollars, of both capital and profit. In each case it is advisable and necessary to judge the value of such guarantees, which must be equated with the status of the country and the state of world conditions. They will probably change in each country with changes of government and the tide of fortune. One must be selective as to each investment. It is my belief that it is advisable to limit the period of any agreement with local partners abroad to no more than 10 years, renewable by mutual consent. Thus changes in the local political situation affecting foreign investments would be a more limited target for any adverse moves than in the case of a U. S. concern owning 100% of an enterprise, and taking out of a country what it may term in later years as excessive profits may have repercussions. Today, however, it is possible to obtain certain protection and guarantees from the International Cooperation Administration in Washington on foreign investments. They are presently available only for certain localities. This, too, is a matter to be investigated in each case.

It is necessary to warn those who look upon export business as something just to tide over bad times in the U. S. that they should keep out of the field, for their own sake, as well as for the reputation of all other U. S. exporters. They will only be disappointed and serve to build up more of the unfavorable foreign image of U. S. companies.

SOCIAL RELATIONS IN FOREIGN TRADE

The U. S. manufacturer must change his attitudes for the overseas markets. He must not expect rapid results. He must have the vision to build for the future on a stable and firm foundation, which includes besides good merchandise, such aspects as friendship, good service, good will, proper export packing and adequate terms.

Another phase to be considered is that overseas people place great value on the personal aspects of a business relationship. They expect the exporter to become acquainted with and interested in their family life as well. They wish to know him as a person, besides a business contact. So many U. S. travellers fail to realize the necessity for accomplishing this, whereas the British, Dutch and Germans do understand it and succeed in building up permanent and sound relationships. They spend the necessary time in each place to carry out this part of their mission. Building up this kind of strong and personal relationship pays, as people overseas are usually very loyal and stay with their friendly suppliers. They feel that the exporter is their personal friend, looking after their interests.

OTHER CONSIDERATIONS

For the overseas markets, one should be a student of the political as

well as of the economic situations in each area. He should read not only our export magazines, but also papers like the Manchester Guardian and economic publications from Holland, Japan, etc. In this way one can keep abreast of the news of any basic changes that may occur in each country, and which may not be mentioned in detail, if at all, in our own papers.

World markets are expanding—the opportunity is here. Export expansion requires fostering and nurturing and careful planning, together with foresight and courage. I have pointed out the risks, and if these factors are kept in mind, the opportunity for a manufacturer to build up a second line of defense against any deterioration of his domestic business, can be realized. We see all around us evidence of the avidity with which British, Italian, German and other manufacturers are going after the export markets. Also, we see the great success of many U. S. manufacturers, who have properly developed the export markets. More American companies should participate in this trade and accountants can help in this respect.

The Objective Responsibility of Business

What, essentially, is the nature of the objective responsibility of business? I think the answer is easy. It involves the realization that any economy, of whatever character, is justified ethically only as it meets the basic needs of the community. And that economy which not only best satisfies these basic needs but helps to give a higher shape to those needs, as they express themselves in people's manifest desires has the highest ethical justification. This realization, I think, puts producers and advertisers in a proper perspective. To do what one can to shape new desires in people, regardless of whether this is to people's best interest—as the advertising profession is constantly trying to do—is an act of the utmost irresponsibility. In the annual Felix Adler lecture delivered here last Wednesday evening, Prof. Adolf A. Berle remarked that the present taste of the American people is on a higher level than most of the products which are being offered to them for their consumption. And I am saying that an economy which genuinely justifies itself ethically would not be behind public taste, it would be taking leadership in its formation. This is partly why Prof. Galbraith of Harvard and many other contemporary economists are so deeply concerned in their analyses of the affluent society. We have solved the problem of production. We have not truly begun even to raise the question of what kind of production, for whom, to serve what end.

Jerome Nathanson, Business Practices and Business Ethics, The Ethical Platform, March 27, 1960

State and Local Taxation

NEW YORK STATE TAXATION

Conducted by Philmore H. Friedman, CPA

POSSIBLE FRANCHISE TAX SAVING UNDER CAPITAL METHOD FOR PREVIOUSLY CLASSIFIED REAL ESTATE CORPORATIONS

As a result of legislation enacted earlier this year, all corporations previously classified as real estate corporations for franchise tax purposes will, beginning January 1, 1962, become subject to the business corporation franchise tax under Article 9A. Many of these corporations will find that the franchise tax computed under the capital method will produce a higher tax than that computed under the income method primarily because of high depreciation deductions. Bernard Werner, a member of the Society's Committee on New York State Taxation suggests, however, that a careful study of the tax base may result in a substantial reduction of the tax thought to be due under the capital method. He submits that two items which enter into the computation should be of particular interest to former "real estate" corporations.

Mortgage Debt May Reduce Capital Subject To Tax. Generally, only current liabilities may be deducted from the total average fair market value of all the taxpayer's New York assets in arriving at capital subject to the one mill tax. The Regulations, however, make an exception for certain long-term liabilities. Where a corporation owns property subject to a debt for which it is not personally liable, only the equity in the property over and above such debt is included in the assets. Thus, an important distinction is made between property purchased subject to a mortgage and property purchased where the mortgage is assumed by the buyer. The same distinction exists between a new mortgage (including a purchase money mortgage) signed by the true mortgagor and one executed by a nominee corporation for the purpose of minimizing the owner's liability thereon. While there does not appear to be any equitable reason for the disparity in treatment between the two types of liens, the existence of the Regulation may result in many former real estate corporations finding their tax as business corporations actually less burdensome than their prior tax under Article 9, even though it was computed at one-quarter mill on the fair market value of all their assets. This rule, therefore, provides an additional reason for the use, whenever feasible, of nominee corporations for the acquisition of property or for the

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execution of mortgages. Moreover, it is evident that, before determining the franchise tax under the capital method, the nature of mortgage liabilities must be carefully determined.

Tax Proration Possibility For Fiscal Year Corporations. It is not an uncommon practice for a corporation in the real estate field to form a separate corporation for each acquisition of real estate. Frequently, the initial fiscal year of the new corporation is less than a twelve-month period. The Regulations provide that, when the capital method applies, the taxable capital for the short period should be determined by multiplying the average fair market value of the assets (less deductible liabilities) by the number of calendar months or major parts thereof included in the period, and dividing the product thus obtained by twelve. Therefore, the short-period tax under the capital method is only a proportionate part of a full year's tax.

An interesting question is presented with respect to those corporations with a taxable year other than the calendar year which are presently classified as real estate corporations. For the period between January 1, 1962 and the close of their first fiscal year ending after that date such corporations are required to pay the regular business corporation franchise tax (in addition to the special 2% tax on net worth in excess of paid-in capital). If the tax for that period is computed under the capital method, it would appear that each such corporation is entitled to pro-rate its tax as indicated in Regulation Article 336. However, the Tax Commission has not yet ruled on the applicability of that Regulation to the automatic reclassification imposed by the new law. Of course, if after proration the tax computed under the capital method is less than either the minimum tax or the tax computed under the income or the income plus salary method, then the greater tax is payable.

It is interesting to note in this connection that the real estate corporation tax law (Sec. 182, Article 9) specifically provided that the tax thereunder is to be prorated where a corporation becomes subject to tax under Article 9-A during any year. The Tax Commission has never issued regulations on the real estate corporation franchise tax, but it appears that such provision would not apply under the new law since the privilege period for that tax was not the corporation's fiscal year but the calendar year, and automatic reclassification will occur as of the close of the 1961 calendar year.

CAPITAL LOSS CARRY-OVER MAY NOT BE DEDUCTIBLE BY RESIDENT CHANGING TO NON-RESIDENT

An interesting conformity problem involving a non-resident was recently considered by Theodore Schnoll, a member of the Society's Committee on New York State Taxation.

Taxpayer, a N. Y. resident during 1959, incurred a very large capital loss from the sale of securities during that year. He took a deduction of $1,000 on his Federal income tax return but could not take the deduction on his N. Y. State resident income tax return. On Jan. 1, 1960 the taxpayer became a non-resident of New York but continued doing business in New York as a sole proprietor. During 1960 taxpayer sold machinery and equipment on which there was a substantial gain.

For Federal income tax purposes, the taxpayer applied his capital loss carry forward (from 1959) against the Sec. 1231 gain. However, taxpayer had to file a *non-resident* New York State income tax return for 1960 and thus could not obtain any benefit

from the 1959 carry-over even though it was an item on his 1960 Federal return. The gain from the sale of the machinery was taxable to the non-resident for New York State income tax purposes because it arose from N. Y. sources, but the capital loss carry-over from 1959 which arose from the sale of securities is not a deduction allowable to a non-resident under Sec. 632. Accordingly, it appears that the capital loss will be lost to the non-resident even though it was incurred at a time when the taxpayer was a resident.

DEDUCTION ALLOWED FOR LIFE INSURANCE PREMIUMS EVEN THOUGH NOT PAID

An inquiry was made of the New York State Tax Commission as to whether a taxpayer may deduct life insurance premiums incurred during the year which were not paid but applied against a loan on his policy.

The New York State Tax Commission replied that the life insurance premiums were paid by incurring the loan on the policy and, therefore, would be deductible within the limitations prescribed by the statute.

STATE TAXATION, OTHER THAN NEW YORK

Conducted by S. ZACHARY SCHEER, CPA

PROPOSED FEDERAL LAW AFFECTING STATE INCOME TAX ON NON-RESIDENTS

An attack on the constitutionality of the New Jersey "Commuters' Tax" (which Act was reported in the August 1961 department) has resulted in an effort to bolster the Act by Federal legislation. The attack on the constitutionality of this Act is based on its discriminatory imposition of an income tax on an isolated group, namely, commuters—New Jersey residents commuting to employment in New York and New York residents commuting to employment in New Jersey. Apparently the question of constitutionality is quite disturbing to New Jersey authorities, for a New Jersey Senator has introduced a bill in the United States Senate to legitimatize the situation embraced in the New Jersey Emergency Transportation Act.

The bill (S.J.R. 111) proposes an amendment to the United States Constitution (which will require ratification by the legislatures of three-quarters of the states to become effective) providing that no state or local taxing district could tax compensation for personal services paid or due an employee unless the employee is domiciled in the taxing state at some time during the period for which the tax is imposed or resides in the state for at least half the period for which the tax is imposed. However, these limitations would not prohibit the uniform imposition by a state, or its political subdivisions, of any tax on compensation paid or due an employee for personal services — whether or not the employee is domiciled in or is a resident of the state — if the proceeds of such tax are used only to provide benefits to which all such persons are eligible, or may become eligible, to receive.

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Obviously, this bill would give New Jersey the exact result they hope to achieve with the New Jersey Emergency Transportation Act — New York State would be prohibited from taxing New Jersey residents working in New York but New Jersey would be able to tax New York residents working in New Jersey.

(Editor's note: — I do not believe S.J.R. 111, in its proposed form, has a ghost of a chance of passing.)

WITHHOLDING FORMS FOR CONNECTICUT EMPLOYERS OF NEW YORK RESIDENTS

Under the new Connecticut law (reported in the August 1961 department) Connecticut employers, who either have New York offices or transact business in New York, are required to withhold New York income tax from salaries of New York residents working in Connecticut. Other Connecticut employers are permitted to withhold, and may elect to do so.

The New York State Department of Taxation and Finance has issued two new information forms which are to be filed on or before April 15, 1962 by Connecticut employers of New York residents if such employers do not withhold the New York personal income tax from the wages of such employees. These forms are:

IT-2102.8 — Special Employer's New York State Information Report

IT-2102.9 — Transmittal of Special Employer's New York State Information Reports (Forms IT-2102.8)

The Connecticut employer who does withhold, will file the regular New York State Withholding Forms (IT-2102 and IT-2103).

LOUISIANA DISTINGUISHES INTANGIBLES FOR FRANCHISE AND INCOME TAX FORMULAS

In a recent case (*United Gas Corp.*), the Louisiana Supreme Court indicated how the income from the same intangibles can be held subject to income tax but not to franchise tax.

The taxpayer is a foreign corporation maintaining its principal place of business in Louisiana. The intangibles involved were profit from a sale of stock held in a corporation doing business in Louisiana, dividends from this stock, and interest from the Federal Government on a refund of income taxes. The Court stated that the income tax law authorizes the inclusion of income from intangibles in the computation of allocable income from Louisiana sources under either the "business situs" or the "commercial domicile" theory. If income is interest, dividends and profits from securities that have acquired a "business situs" in another state, that income is allocated to the state of "business situs." If no "business situs" is established in another state, the income is allocated to the state of "commercial domicile." That is, the state where the principal place of business is located and from which the corporation's activities are controlled and take place. In this case, since Louisiana is the taxpayer's commercial domicile and since its intangibles had no busines situs in any other state, the entire income is allocable to Louisiana.

The franchise tax law is distinguished from the income tax law. It does not provide for the allocation of intangibles to the state of commercial domicile. The franchise tax is based upon assets produced in the state or used in the taxpayer's local business operations to the end that they have acquired a "business situs" in the state. In this case, it was ruled that the stock

owned by the taxpayer was never employed in its Louisiana activities and therefore did not acquire a "business situs" in the state. Therefore, these intangibles are not allocable to Louisiana for franchise tax purposes.

ILLINOIS RETAILERS' OCCUPATION (SALES) AND USE TAX

Through a series of bills recently enacted, this law has been broadened considerably.

Very briefly, it now imposes a tax on materials and services on out-of-state sellers maintaining a representative in Illinois and also on orders solicited in Illinois through catalogs or other advertising. It further states that solicitation through catalogs or advertising makes the seller a retailer, liable for the collection of the tax, and automatically appoints the Secretary of State as the seller's agent upon whom process may be served.

A new Service Occupation Tax and its complementary Service Use Tax has also been established. These taxes are levied on purchases of personal tangible property to be used in connection with a sale of services, as, for example by an advertising agency. The tax is paid to the supplier, based upon the cost of the property. The rate is 3% rate, plus an additional maximum of one-half of 1% that can be levied locally by cities and counties.

The basic Sales and Use Tax (not the same as the one just discussed) has been increased to an effective rate of 4%, which includes 3½% for the state and ½% for the municipality.

MUNICIPAL AND LOCAL TAXATION

Conducted by Robert I. Edelson, CPA

SPECIAL TAXES IN NEW YORK STATE

A prior column listed various cities and counties in New York State that impose sales and use taxes. The following listing of some of the other special taxes imposed by local jurisdictions should be of interest to practitioners.

Hotel Occupancy taxes are imposed at a 3% rate by Jefferson County, and the cities of Long Beach and Watertown.

Consumers Utility taxes, usually at a 3% rate, are imposed by more than a dozen cities in the state. A *Food and/or Drink Tax* at 3%, where the total charge is $1.00 or more, is levied by the City of Long Beach. The City of Watertown imposes a similar tax on Food and/or Drink.

A 15% Admissions Tax on harness racing is levied by the counties of Erie, Genesee, Oneida, Saratoga, and Sullivan. Nassau County imposes a tax of 30% on harness racing and 15% on flat races. Westchester County levies a 5% tax on harness racing. The cities of Batavia and Saratoga Springs impose a similar tax at a 15% rate, while Yonkers has had a 30% rate.

A detailed study of local laws is essential to proper representation of clients in various localities of New York State.

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NEW YORK CITY REALTY TRANSFER TAX UPHELD

The New York City realty transfer tax is imposed on transfers of property located in the City of New York even though title closing occurs outside the City. This power to tax transfers, regardless of where the transfer took place, was given to the City by virtue of Chapter 785, laws of 1960, which amended the enabling act under which the Real Property Transfer Tax is imposed.

The constitutionality of the law was upheld by the Supreme Court, New York County in *re Samkoff* v. *Gerosa.* The court held that the City did not have to re-enact the local law in its entirety, and that the purpose of the amendment was to clarify the scope of the City's authority.

WHEN CONSTRUCTION IS COMPLETE, FOR N. Y. CITY TAX PURPOSES

The case of *Staten Island Plaza Inc.* v. *Tax Commissioners,* — Supreme Court, Richmond County clarifies some of the conditions that determine exemption from assessment as "a building in the course of construction."

Section 157-1.0 of the New York City Administrative Code provides that "A building in the course of construction since the preceeding 25th day of January and not ready for occupancy on the 25th day of January following, shall not be assessed unless it shall be ready for occupancy or a part thereof shall be occupied prior to the 15th day of April—"

The taxpayer contended that there was no improvement value for the year 1957-1958, since rents were not paid under the leases until April 25, 1957, and temporary certificates of occupancy were issued on April 27, 1957. However, evidence showed that several tenants were occupying stores prior to April 15, 1957 and were setting up counters, marking merchandise, and doing office work.

The court held that the buildings were partly occupied prior to April 15, by virtue of actual physical occupation by tenants, and taxpayer was not entitled to tax exemption on the improvements.

PROPOSED CHANGES IN NEW YORK CITY TAXES

Two bills have been introduced in the New York City Council, which, if enacted, will affect the sales tax and the admissions tax.

Bill 605 would reduce to 3% the city sales tax on meals and alcoholic beverages, effective September 1, 1961.

Bill 610 would exempt from the admissions tax admissions to theatrical, operatic and musical concerts. This exemption would apply to charges paid on or after September 1, 1961 for performances to be given on and after October 1, 1961. THE END

Accounting and the SEC

Conducted by Louis H. Rappaport, CPA

SEC SPECIFIES BOOKS AND RECORDS TO BE MAINTAINED BY INVESTMENT ADVISERS

Under the 1933 and 1934 Acts, the SEC has broad powers with respect to financial statements filed with the Commission. The statutes confer wide discretionary authority on the Commission to prescribe the form of financial statements, to define accounting and technical terms, and to specify the items or details to be shown in statements. The Commission is authorized to prescribe the methods to be followed in the determination of depreciation, in the preparation of consolidated financial statements, and in the differentiation of recurring and nonrecurring income. Under these statutes, however, the SEC is not authorized to prescribe the detailed accounts and records to be kept by companies under Commission jurisdiction.

Under the Holding Company Act of 1935, the Commission has even broader powers, and pursuant to such authority the SEC has promulgated two uniform systems of accounts: one for public utility holding companies, and one for mutual service companies and subsidiary service companies.

The Investment Advisers Act of 1940 is also administered by the SEC. A recent amendment to that Act provides that every investment adviser subject to the Act shall make, keep and preserve such accounts, correspondence, memoranda, papers, books and other records, and make such reports, as the Commission may prescribe. Such books and other records are subject to inspection by Commission representatives.

Effective July 1, 1961, the SEC adopted Rule 204-2 under the Investment Advisers Act. The rule is a comprehensive listing of the books, records, papers, and memoranda which investment advisers subject to the Act must keep and preserve.

Paragraph (a) of the rule specifies the books and records which investment advisers are required to keep. These include the usual cash receipts and disbursements journals and other books of original entry, and ledger accounts; memoranda of orders given and instructions received for the purchase, sale, receipt or delivery of securities; and originals or copies of certain communications received or sent by the investment adviser; trial balances, financial statements, and internal audit working papers.

Paragraph (b) of the rule requires investment advisers who have custody or possession of securities or funds of any client to maintain certain additional records. These include a separate ledger account for each such client; copies of confirmations of transactions in the account of any such client; and a position record for each security in which any such client has a position, showing the interest of the client and the location of the security.

Paragraph (c) of the rule is applicable to investment advisers who render any investment supervisory or management service to any client. Such

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investment advisers are required to maintain the records indicated with respect to the portfolio being supervised or managed and to the extent that the information is reasonably available to or obtainable by the investment adviser.

Paragraphs (e) and (f) of the rule specify the period during which the books and records must be preserved. Under paragraph (f) an investment adviser, before ceasing to conduct business, is required to arrange for and be responsible for the preservation of his books and records for the remainder of the period specified in the rule, and to notify the Commission of the place where such books and records will be maintained.

Readers interested in the complete text of the rule are referred to Release No. 114, under the Investment Advisers Act of 1940. THE END

Administration of A CPA Practice

Conducted by MATTHEW P. GERAGHTY, CPA

STAFF TRAINING COURSE AVAILABLE FOR SMALL AND LARGE FIRMS

The editor of this column has recently had the opportunity to become well acquainted with the American Institute of Certified Public Accountants training program for new staff assistants, having served as a discussion leader and lecturer during the two-week course presented at Bowling Green State University, Bowling Green, Ohio.

Approximately eighty staff accountants, representing small and medium-sized firms, mostly from the mid-western section of the country, attended the two-week course. All of the course participants, with the exception of one or two from the local area, boarded at the University.

Identical courses were also given during the summer at five other universities distributed somewhat evenly throughout the country, a factor which helps to minimize the transportation costs incurred.

The course is extremely intensive as anyone who has participated in the course, particularly discussion leaders, will testify. Classroom and evening study assignments keep all participants well occupied from 8:30 a.m. to 10:30 p.m. on each day of the course except Fridays.

The enrollment fee for each registrant is $275 and it covers the cost of all materials, and room and board for the two-week period.

The training program is designed to bridge the gap between the college classroom and the certified public accounting office. The participants are employees of and are sponsored by the small and medium-sized accounting firms throughout the country. All of the participants are beginning accountants—some with up to eighteen months of experience and some without any experience.

The course material covers areas of paramount interest to the new staff assistant—namely, professional ethics and responsibilities, evaluation of internal control, audit procedures and techniques, tax return preparation and the preparation of non-opinion statements.

It is presented in a series of lectures, case discussions, problem-solving sessions, and independent study assignments. The participants are divided into groups of approximately twenty each for the case discussion and problem-solving sessions.

In addition to the technical sessions, "toastmaster sessions" are scheduled during the course to help the staff accountant develop the skills required in speaking before small groups, both ex-

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temporaneously and on a prepared basis. Several sessions are also devoted to effective writing, primarily for the purpose of creating in the staff accountant an awareness of the importance of written communications.

Three examinations are given during the course: an AICPA orientation test to determine the participant's ability and background, an AICPA achievement test, level II, to evaluate his accounting skills, and a third examination covering material developed in the course. The results of the examinations, together with the discussion leader's comments, form the basis for evaluating the performance of each individual. A copy of the evaluation report is also mailed to the participant's firm.

It is this writer's conclusion that the course is comparable in quality with new staff assistant training courses conducted by the largest public accounting firms and that it now places within the economic reach of every progressive practitioner, regardless of size, a first-rate training program for new staff assistants.

MANAGEMENT OF AUDIT STAFF ASSIGNMENTS

An interesting article entitled "Audit Staff Organization," written by Derek C. R. Horne, C.A., appeared in the April, 1961 issue of the CANADIAN CHARTERED ACCOUNTANT.

In this article Mr. Horne discusses what he considers to be the two basic types of organization employed to achieve effective utilization of audit staff personnel. The two types are referred to as the "pool" and the "group or staff."

Pool System. In the pool type of organization, the partners together with their supervisors schedule the assignments and determine the manpower requirements. The schedules are then submitted to the pool manager who provides the necessary manpower and who is also responsible for coordinating the reassignment of the personnel.

Group System. Under the group system, the audit staff is divided into manpower groups of similar abilities and experience levels. Each group is responsible for scheduling and carrying out its own assignments. Under this system, no pool or audit staff manager is required. However, a personnel manager would be needed to recruit new staff assistants for each group.

Advantages of Each System. Of the advantages listed by the author for each type of system the more important ones appear to be as follows:

For the Group System

Evaluation of a staff member is more easily accomplished.

Members of a group get to know one another's work habits and capabilities in shorter time, particularly the partner's preferences. The partner in turn is better able to effect observance of his individual preferences.

A spirit of constructive competition and rivalry can be developed among the groups.

For the Pool System

Reassignment of staff personnel can be accomplished with a minimum of trouble when it is done on a staff-wide basis.

Overall staff requirements are more easily determined and constant review by individual groups is eliminated.

Excess staff man-hours should be fewer because of the tendency in the group system to acquire "fat" during the busy part of the season.

Total administrative time required in scheduling and assigning per-

sonnel is probably less when the function is carried out by one individual, the pool manager.

Greater opportunities exist for staff personnel in acquiring diversification and depth in experience.

Out-of-town work and overtime can be more evenly distributed among the staff.

Personality conflicts are lessened since the locked-in element of the group situation is not present.

Of particular interest in this article is the author's statement that the majority of medium and large-sized firms use the group basis of audit staff organization. It is not known whether the author is referring in this statement solely to Canadian firms or whether he is also including firms within the United States.

Although Mr. Horne does not categorically recommend the pooling system over the group system, the tenor of his article implies that he favors the pooling system.

The editor of this column feels that although the group system might be easier to administer, the advantages of the pool system in achieving optimum utilization of manpower, far outweigh that of the group system.

Carrying the pool system one step further, the pool or staff manager should, in addition to allocating and coordinating the audit staff personnel, be responsible for scheduling all assignments and determining the manpower requirements of each assignment. Under such a pool system, the complete responsibility for the effective utilization of staff personnel is placed in the hands of one individual.

Next, the firm should determine what its objectives are, in the utilization of staff personnel. Typical objectives, which were discussed in a previous article in this column, entitled "Effective Utilization of Audit Staff Personnel," (June, 1961), may be stated as follows:

Continuity of personnel on recurring assignments

Progressive development of staff personnel

Equalization of travel time

Suiting staff personalities to the job

Matching staff abilities with job requirements

Servicing clients promptly and efficiently

Minimization of unassigned time

Flexibility

With stated objectives and with responsibility clearly delegated and pinpointed, the rest of the battle is just hard work.

Payroll Tax Notes

Conducted by SAMUEL S. RESS, CPA

SUMMARY OF FAIR LABOR STANDARDS AMENDMENTS OF 1961

On May 5, 1961, President Kennedy signed Public Law 87-30, amending the Fair Labor Standards Act. This major development revises the minimum wage law in two principal respects, namely: a) the minimum wage level is increased and b) more employers (and consequently more employees) are brought within the purview of the Act.

The amendment extends coverage to employees of large enterprises engaged in retail trade or service, and of other enterprises in commerce or in the production of goods for commerce. Newly covered employers in the retail and service trades are required to pay a minimum wage of at least $1 an hour. This provision will not affect New York retailers who must pay a minimum wage of $1 an hour under the State law. However the Federal enforcement and penal provisions may become operative in the event of a violation.

It increases the minimum wage, in two steps, to $1.25 an hour. One hundred and twenty days after the enactment of this measure, on September 3, 1961, the first effects of this measure—an increase in the minimum wage from $1 to $1.15 an hour for employers heretofore covered by the law, went into effect.

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NEWLY COVERED BUSINESSES

The amended Act applies to employees who are engaged in interstate commerce or in the production of goods for interstate commerce, whose employers fall into the following five categories:

1. Any enterprise which has one or more retail or service establishments if the gross annual volume of sales of the enterprise is not less than $1 million and if such enterprise purchases or receives goods for resale that move or have moved across State lines (not in deliveries from the reselling establishment) which amount in total annual volume to $250,000 or more;
2. Any such enterprise engaged in an interurban or metropolitan transit business if the gross annual volume of sales of the enterprise is not less than $1 million;
3. Any division of an enterprise that is not included in the other categories and which division has employees engaged in commerce or production of goods for commerce, if the annual gross volume of sales of the total enterprise is not less than $1 million;

4. Any enterprise engaged in construction or reconstruction, if the annual volume is not less than $350,000;
5. Any gasoline service station if the annual gross volume of sales is not less than $250,000.

MINIMUM WAGE

For workers to whom a minimum wage of $1.00 an hour had applied under the old law, the rate is increased as follows:

$1.15 beginning September 3, 1961 and
$1.25 beginning September 3, 1963.

For workers newly brought under the Act, the rates per hour are:

$1.00 beginning September 3, 1961.
$1.15 beginning September 3, 1964.
$1.25 beginning September 3, 1965.

WAGE ORDERS IN PUERTO RICO AND VIRGIN ISLANDS

A two-step increase in *existing wage orders* in these areas is also authorized (1) 15% within 60 days after the effective date of the bill or one year from the effective date of the most recent wage order, whichever is later; (2) 10% two years after the 15% rate goes into effect. Different rates could apply if they are recommended by review committees appointed in accordance with procedures in the Act.

The minimum wage rates for employees in these areas who are *newly covered* would be established by wage orders effective no sooner than 60 days after September 3, 1961.

OVERTIME PREMIUMS

For workers newly brought under the overtime provisions, compensation at a rate not less than 1½ times the regular rate of pay is required for workweeks in excess of:

44 hours beginning September 3rd, 1963.

42 hours beginning September 3rd, 1964.

40 hours beginning September 3rd, 1965.

EXEMPTIONS

Employees in certain industries and occupations who would otherwise be entitled to the protection of the minimum wage and overtime provisions of the Act are specifically excluded. Some of the changes in these exemptions are as follows: The minimum wage and overtime exemption for employees employed in a local retailing capacity is removed. An otherwise qualified employee of a retail store shall not be excluded from the exemption for bona fide executive and administrative employees so long as he spends less than 40% of his time in non-executive and non-administrative work. The minimum wage and overtime exemptions for retail and service establishments are changed to exclude establishments in newly covered enterprises. However, the present exemption continues for any such establishment having annual sales of less than $250,000.

In addition, the following types of establishments are excluded from the new coverage provisions:

Hotels, motels, restaurants, motion picture theatres and hospitals; schools for physically or mentally handicapped or gifted children; institutions which are primarily engaged in the care of the sick, aged, mentally ill or defective, residing on the premises; amusement or recreational establishments operated on a seasonal basis. The minimum wage exemption for employees engaged in processing (except canning) and distributing fish and related products is limited to off-shore activities.

Minimum Wage anl Overtime Rule Exemptions.

- Switchboard operators of independently owned telephone companies which have no more than 750 stations.
- Employees of retail store lunch counters, certain caterers and similar retail food services.
- Employees in agriculture even though they also perform certain livestock auction operations in which their employer is engaged as an adjunct to the raising of livestock. In order for the exemption to apply, the employee would have to be primarily employed in agriculture and would have to be paid the minimum wage required by the Act for his work in connection with livestock auction operations.
- Employees engaged in ginning cotton for market in any place of employment located in a county where cotton is grown in commercial quantities.
- Employees within the "area of production" by a country elevator, if not more than 5 employees are employed in the establishment in such operations, notwithstanding that such an establishment sells products and services used in the operation of a farm.
- Employees of a retail or service establishment primarily engaged in selling autos, trucks, or farm implements.
- Farm workers employed in growing and harvesting of shade-grown tobacco who are engaged in processing such tobacco, prior to the stemming process, for use as cigar wrapper tobacco.
- Certain employees engaged in transporting workers to harvest fruits or vegetables or transporting the fruits or vegetables from the farm to the place of first processing or first marketing within the State.

Overtime Exemptions.

- Employees of gasoline service stations.
- Announcers, news editors or chief engineers of a radio or television station having its major studio (A) in a city of 100,000 or less, except where such city is part of a metropolitan area having a population in excess of 100,000, or (B) in a city of 25,000 or less, which is a part of such an area but is at least 40 airline miles from the principal city in such area.
- Employees of certain independently owned and controlled local enterprises engaged in the wholesale or bulk distribution of petroleum products.
- Employees of retail or service establishments who receive more than half their pay over a representative period in commissions.
- Certain drivers or driver's helpers paid on the basis of trip rates or other delivery payment plan.

Minimum Wage Exemption.

- In the case of seamen, it is limited to those employed on a vessel which is not documented or numbered under the laws of the U.S.
- In the case of employees of certain transit systems, it is limited to employees not in an enterprise described in the new coverage provisions.

Minimum wage, overtime and child labor exemption.

- Homeworkers engaged in making holly wreaths composed principally of evergreens, and those engaged in harvesting the forest products used in making such wreaths.

OTHER PROVISIONS

The protection of the child labor provisions is extended to enterprises engaged in commerce or in the production of goods for commerce. The courts are authorized, in an injunction proceeding, to order the payment of minimum wages or overtime compensation found by the courts to be due employees. The Secretary of Labor is directed to study the complicated system of exemptions now available for the handling and processing of agricultural products under the Act, and the problems involving rates of pay of employees in hotels, motels, restaurants and other food service enterprises that are now exempt from the Act, and to report to the Congress in January 1962.

The Secretary is authorized to issue regulations or orders providing for the employment of full-time students in retail stores at rates below the general statutory minimum, provided that such employment is not of the type ordinarily given to a full-time employee.

The definition of "wage" is amended to authorize the Secretary to determine the fair value of board, lodging, and other facilities for defined classes of employees and in defined areas. It also excludes the cost of such facilities from wages if it is excluded under the terms of a bona fide collective bargaining agreement.

HOW TO DETERMINE WHETHER OR NOT CLIENT MEETS EXEMPTION TESTS

The first thing to do is to make a dollar volume test. As indicated heretofore the retail employer is exempt if

(1) Gross sales are less than $1 million dollars *annually*, or

(2) Less than $250,000 in out of state goods were purchased for resale. Construction companies doing less than $350,000 in gross sales and gasoline stations doing less than $250,000 a year in gross sales are exempt.

Annual gross sales consist of receipts from sales, services or both. To determine whether or not the employer is covered for any calendar quarter, use the gross sales volume of the 12 month period immediately preceding that quarter. It must be borne in mind that the employer must pay the minimum wages in force during the year he becomes covered. If a fourth quarter spurt in sales puts the employer over the exemption limit, the minimum wage must be paid for the entire year, but not for any period prior to September 3, 1961.

Excise taxes can be deducted from gross sales if they are billed separately. New businesses have to use their first quarter's sales to project annual sales. They are covered if the projection indicates annual sales over the exemption limit.

TYPES OF RECESSIONS

Each of the postwar recessions represents a different recession "model." It is perhaps possible to divide recessions into three broad types: (1) inventory recessions, resulting from miscalculations by business in building up excessive stocks of goods; (2) capital goods recessions, caused by the exhaustion of a wave of expansion in producers' equipment and construction; and (3) recessions caused by government—through cutbacks in expenditures, increases in taxes or excessive tightening of money. Obviously, any given recession may represent a mixture, in different proportions, of some or all of these elements.

LEONARD S. SILK, "Anatomy of Four Recessions,"
CHALLENGE, July 1961

Federal Taxation

Decisions and Rulings—RICHARD S. HELSTEIN, CPA

Commentary —Committee on Federal Taxation
Chairman, ARTHUR J. DIXON, CPA

DECISIONS AND RULINGS

LIQUIDATION VS. REORGANIZATION

In a new ruling, the Commissioner has attempted to close another "bail-out" loop-hole. In the situation where, within a 12 month period following the adoption of a plan of complete liquidation, a corporation sold all of its assets to a new corporation (formed by the management of the old corporation) for cash, long-term notes and 45% of the stock of the new corporation (the balance being sold to the public through underwriters), the distribution in liquidation of the old corporation of the cash, notes and stock of the new corporation represents a dividend to the extent of the accumulated earnings and profits of the old corporation.

The transaction represents a reorganization within the meaning of Section 368 (a) (1) (E) and (F) of the Code, since, the Commissioner reasons, "the newly formed 'purchasing' corporation was utilized to effect, in substance, a recapitalization and a change in identity . . . of the 'selling corporation'." The sale of 55% of the stock to the public was a separate transaction, and, further, in view of *John B. Nelson Co.* v. *Helvering* (S. Ct. 1936, 296 U. S. 374) surrender of control in the new corporation does not mark a discontinuity of interest by stockholders of the old corporation.

Stating unequivocally that the transaction was designed "to withdraw accumulated earnings from the corporate enterprise for the benefit of the stockholders, while they nevertheless continued a substantial equity interest in the enterprise," the Commissioner denied that there was any "reality" to the sale of the assets or to the liquidation. Such an avoidance of dividend taxation was not the intent of Congress in enacting Section 337.

Furthermore, rules the Commissioner, since the public sale of stock was a separate transaction, the distribution was taxable to the stockholders as an ordinary dividend under Section 301 rather than as "boot" under Section 356 (a) (1) and (2).

At the same time the Commissioner announced the revocation of Rev. Rul. 56-541 (1956-2 CB 189) which held that the cash and notes received by the shareholders were to be treated as in payment for the stock of the old corporation. The new ruling is not to be applied to any transaction consummated prior to August 21, 1961 where the taxpayer relied on the Commissioner's prior position to his detri-

ment. (Rev. Rul. 61-156, IRB 1961-34, 10).

APPEALS COURTS CONFLICT ON MEDICAL EXPENSES

It is probable that many accountants, upon giving an equivocal or qualified answer to what appears to be a simple 'yes' or 'no' tax question, are faced with the comment: "If you can't give a definite answer, how can a layman be expected to know what is proper under the tax law?" Apparently *nothing* is unqualifiedly black or white under the Code, and the interpretation of the meaning of identical words may vary widely no matter how learned and tax-wise the interpreter. This is certainly the implication in the recent five to four Supreme Court decisions, and is emphasized by the conflicts in the Courts of Appeal.

In the July issue of the NYCPA, p. 498, we discussed in some detail the reasoning of the Third Circuit Court of Appeals in holding that the cost of lodgings in Florida was deductible to a taxpayer who had been ordered there by his doctor because of a heart condition. (*Com.* v. *Robert M. Bilder* CA-3, 4/7/61).

In a companion case involving *Max Carasso* (see NYCPA December 1960 p. 858 and October 1960 p. 716) the Second Circuit has reached a decision which is diametrically opposite of that in *Bilder*. Reviewing the same legislative history and the same Committee Reports, the Second Circuit came to the conclusion that Congress specifically meant to exclude as a deduction, meals and lodging while away from home receiving medical treatment. In its opinion, the Court referred to the *Bilder* case and stated:

> "The majority held that the taxpayer was entitled to deduct amounts spent for lodgings, as well as transportation to and from Florida, as medical expenses. A dissent was filed by Judge Hastie in which he came to the conclusion that money spent for lodging during a medical trip was not authorized. This court feels that the relevant statutes and the legislative history surrounding them support Judge Hastie's interpretation." (*Carasso* v. *Com.* CA-2, 7/14/61).

Thus, it is probable that the Supreme Court will grant certiorari and settle the question (by five to four?).

PART OF INSURANCE PROCEEDS TAXABLE AS INCOME UNDER STOCK PURCHASE AGREEMENT

A corporate successor to a partnership has four stockholders of which one was a former partner, A, and one, B, the widow of a former partner. The other two stockholders were employees of the partnership prior to its incorporation, who subsequently acquired stock. The corporation owned insurance policies on the life of A.

Pursuant to an agreement, the policies were assigned in trust to the wife of A and to B, with the understanding that upon the death of the insured the proceeds of the policies were to be used to pay part of the purchase price of the stock owned by A and B. The other two stockholders, who were to purchase the stock at its book value, were to pay 2/3 of the premiums henceforth, and, of course, the difference betwen the insurance proceeds and the price of the stock at the time of purchase. The insured, A, paid the other one-third of the premiums.

In 1954 the insured died. In ac-

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cordance with the agreement, the holdings of B were purchased for $39,591, of which $12,147 came from insurance proceeds and $27,444 was paid by the purchasers, who, over the period from the date of the contract until the insured's death, had each paid $3,052 in premiums.

The Commissioner contended that the difference between the proceeds of the insurance and the premiums paid by the purchasers was income to them. The Court agreed, holding that the policies were transferred for a valuable consideration and therefore came within the exception set forth in Section 101 (a) (2) providing that proceeds of life insurance contracts can be partially taxable. The Court reasoned that "the consideration for the transfer of the . . . policies was the mutuality of obligations and the actual cash consideration paid by the taxpayers . . . in premiums, which was an integral part of the consideration for the assignment of the insurance policies for the use and benefit of the taxpayers." (*Monroe et al v, Patterson* D. C. No. Dist. Ala. 6/28/61).

MAILING OF DEFICIENCY NOTICE TO LAST KNOWN ADDRESS

The I. R. S. has announced that in cases where there has been filed with the Internal Revenue Service a power of attorney which, in addition to authorizing the designated attorney to represent the taxpayers, requests that *all* communications concerning tax matters be sent to the attorney, the "last known address" to which a notice of deficiency is to be mailed within the meaning of Section 6212 (b), is that of the designated representative.

However, if the power of attorney requests that *a copy* of all communications be sent to the representative, a notice sent directly to the taxpayer by registered mail at his last known address will give the Tax Court jurisdiction upon the filing of a timely petition. (Rev. Proc. 61-18, IRB 1961-32, 72).

Since this means that the 90 day period for filing a petition to the Tax Court commences with the mailing of the deficiency notice to the last known address of the taxpayer, it is important that a representative under a power described in the opening paragraph notify the I. R. S. of any changes in his address. If the power of attorney is one described in the second paragraph, changes in his and the taxpayers addresses should be communicated to the Internal Revenue Service.

SUBDIVISION AND SALE OF INHERITED PROPERTY

In 1948, three children inherited a 52½ acre tract of land. The heirs were not in the real estate business, had no use for the property personally, and both desired and attempted to sell the tract from the time it was inherited. However, they could obtain no offers for the tract as a whole.

During the years 1950-1953, two of the children were away, one in the armed services and one in another state on business, so that the management of the inherited property was left to the husband of the third heir. He felt that the best method of disposing of the property could be to subdivide and develop it, but, since the heirs did not have sufficient money to do so, the project was put in the hands of a real estate development company. A separate corporation was formed to carry out the purpose and, during the years 1953, 1954, 1955 and 1956 sales were made of 65 parcels of the property. During the years 1954, 1955 and 1956 distributions of the profits on the sales were made to the heirs. The Commissioner wished to tax these profits as ordinary income received from the sale of property

held by the heirs for sales to customers in the ordinary course of trade or business. The taxpayers claimed that the property sold was a capital asset, and the gains were capital gains.

The Tax Court agreed with the taxpayers. It said that it was obvious that the taxpayers did not personally engage in the real estate business since two of them were out of the state and the sister took no active part in the development and sale of the property. Although the Court stated that "it is well recognized that a taxpayer need not personally conduct the business of subdividing land and selling lots; he may act through agents, in which case the activities of the agents for his benefit are imputed to him," it denied the Commissioner's contention that the actions of the husband and the real estate agency should be imputed to the taxpayers, since the doctrine does not mean that the agent's business is that of the taxpayer. In the instant case, the taxpayers were seeking only to dispose of "what was admittedly a capital asset when it was acquired, and turned it over to their agent . . . for that purpose." They had no control over the property and did not participate in the business beyond signing deeds. Accordingly they were not in the real estate business, and the gains represented capital gains. (Both parties agreed that Section 1237 had no application to this case, and therefore the Court did not consider its applicability.) (*Estate of William D. Mundy,* 36 TC No. 72).

COMMENTARY

ESTATE TAX AND INCOME TAX CONSEQUENCES OF STOCK QUOTED "EX-DIVIDEND"

Included in the gross estate for estate tax purposes are dividends declared prior to death, even though payable on a date after death, provided that the decedent was alive on the record date. When received, these "accrued dividends" constitute income in respect of a decedent (Sec. 691 (a)) and are reflected on the income tax return of the recipient, normally the estate, as dividend income.

Where a dividend is declared on a share of stock before the decedent's death, but payable to stockholders of record on a date after his death, and the stock is selling "ex-dividend" on the date of the decedent's death, the amount of the dividend is added to the ex-dividend quotation in determining the fair market (estate tax) value of the stock as of the decedent's death (Reg. Sec. 20.2031-2 (j)). This is necessary in order to restore to the value of the stock the amount by which its value dropped when the stock went ex-dividend. What are the income tax consequences of the receipt of this dividend by the executor? Application of pertinent law and regulations appears to produce an unusual solution to this question.

The income tax basis of the stock selling "ex-dividend" presumably will follow the general rule. Thus, in the event of subsequent sale or exchange, the amount of gain or loss will be determined by the amount at which the stock was valued on the estate tax return. Thus, if the stock was selling for $10,000 ex-dividend and the amount of the dividend was $500, under the regulation cited, the valuation of the stock to be reported on the estate tax return would be $10,500. This presumably will be the income tax cost basis of the security.

When the $500 dividend is received, it apparently comes under the defini-

tion of income in respect of a decedent. The decedent, owning the stock on the ex-dividend date, is normally entitled to receive the dividend. Since he held this right on the date of death, when the dividend is subsequently received it would be reportable by the estate as dividend income under Section 691 (a). The regular rules governing basis have no application to income in respect of a decedent (Sec. 1014 (c)). It would therefore appear that the stock when sold would retain the basis reflected on the estate tax return, viz. $10,500.

If the stock was sold immediately after death, presumably the proceeds would be $10,000, the quotation of the stock "ex-dividend." Immediate sale would produce the unusual result of a $500 reportable dividend income offset by a $500 short-term capital loss. This treatment would, of course, be advantageous to the taxpayer-estate. Assuming that the dividend was from a qualifying domestic corporation, it would be subject to the dividend received exclusion and credit. On the other hand, within the limits prescribed by the Code, the short-term capital loss would constitute a valid deduction. In addition, the estate may be entitled to a deduction on its income tax return for the estate tax attributable to the dividend (Sec. 691 (c)).

While this result does not appear to be logical, it is the only one apparent from a strict interpretation of the Code and Regulation sections involved. This appears to be an area where the estate and income tax principles do not mesh.

DIVIDENDS RECEIVED CREDIT AND SHORT SALES

When an investor or a trader in securities makes a short sale of stock which he does not own, he must borrow the shares so that they may be delivered to the purchaser. The broker through whom the short sale is made will arrange to deliver the shares and he may use shares he holds in a margin account belonging to another customer if, as is customary, he has been given the authority to do so, or he may borrow the shares from another broker.

If during the period the short sale is open a dividend is paid on the stock, the broker will debit the account of the borrower and credit the account of the lender with an amount equal to the dividend on the number of shares borrowed. It has been recognized in IT 3989, C.B. 1950-1, 34, that the borrower is entitled to a deduction for this amount as a business expense if he is a trader, or as a nonbusiness expense if he is an investor. By the same token, the lender must report the same amount as income.

A question was raised as to whether the short sale payment represents dividend income to which the $50 exclusion and the 4% credit applies. The Internal Revenue Service said "no" in Rev. Rul. 60-177. The only person entitled to the exclusion and credit is the person who purchased the shares when the short sale was made since he thereupon became the real owner.

This ruling creates quite a problem for taxpayers who buy stocks on margin, for brokers, and for Revenue Agents. In most cases, the margin

customer has no way of knowing whether his stock has been used for delivery against a short sale made by somebody else. His monthly broker's statement shows credits for dividends received without any indication whether these are actually dividends or amounts received from a borrower of the stock. Furthermore, the broker may have this customer's shares commingled with those owned by other margin customers and there is no way of identifying the shares of any particular customer as being the ones used for delivery against the short sale.

If the customer claims the dividends received credit, either because he doesn't know that his shares have been delivered on a short sale, or, because he claims that it must have been the shares belonging to somebody else that were so used, how could a Revenue Agent challenge this treatment without examining in detail the broker's transactions in any particular stock where there may have been a short sale? If he found such a case, would he then arbitrarily disallow the credit to one particular customer even though identification is impossible? S.M. 4281, C.B. IV-2, 187 (1925) which dealt with substantially the same problem came to the conclusion that the administrative difficulties involved were considerable, and that it would seem expedient to treat the amounts credited as being dividends in all instances where it was not known that the broker had loaned the stock in question. Unless a similar policy is followed now, the only protection a margin customer would have would be to instruct the broker not to use his stocks for deliveries against short sales.

SALE OF PERSONAL RESIDENCE IN PARCELS

As a general rule, no gain will be recognized on a sale of a principal residence if the owner purchases, or constructs, and uses as his principal residence another one, within specified time limits before or after the sale (Section 1034). The time limit in the case of a purchase is one year, and in the case of construction is one year before the sale and eighteen months after if construction is commenced within one year after the sale. However, in order to enjoy the benefits of nonrecognition of gain the taxpayer must invest in the new residence an amount at least equal to the adjusted sales price of his old residence.

It should be noted that the taxpayer does not have an election concerning the nonrecognition of gain rule, it is mandatory to the extent that the statute and regulations are satisfied.

There will usually be no difficulty in determining the date of sale since it is generally the date on which title passes. Thus, it is a relatively simple matter to determine whether a new residence is acquired within the time limits. However, suppose a taxpayer's principal residence is located on 5 acres of property. He has tried to sell the entire tract since he wishes to construct a new residence, but because of the high price attributable to the acreage he has not been able to find a buyer. He decides to sell the property to five different purchasers, his residence and one acre to one purchaser and the remaining four acres to four other purchasers. Assume he has five separate sales on different dates and that six months elapse between the first and last sale.

If the taxpayer in our example decides to invest the adjusted sales prices from the five sales in the construction of a new residence, which date of sale must be used to measure the time limit of eighteen months? Also, may he consider the five sales as being a sale of his principal residence in order to avoid recognition of gain? Might the Internal Revenue Service allege

that each sale was a separate transaction and that only the gain on the sale of the parcel which included the residence could be deferred under the statute?

In 1954 a revenue ruling was issued on a similar fact situation (Rev. Ruling 54-95). There, a taxpayer purchased land and constructed a house together with other improvements. The property at all times was held by the taxpayer solely for residential purposes as a single integrated unit. In 1952 the taxpayer attempted to sell the property as a single unit but was unsuccessful. However, during 1953 he succeeded in selling the property in two parcels. A gain was realized on the sale of the land while a loss was sustained on the sale of house and other improvements, hence, the taxpayer wished to treat the two sales as one transaction. The ruling indicated that under such conditions the sale of each parcel is treated as a separate transaction. Therefore, gain was recognized on the sale of land but the loss sustained on the sale of the personal residence was not deductible. The ruling did not involve the nonrecognition of gain or loss on the sale of an old residence, since a new residence was not acquired.

In a case decided in 1959 a taxpayer who owned a residence and thirteen acres, sold the residence and three acres in 1950 and the remaining ten acres in 1951. An unsuccessful attempt had been made to sell the property as an entirety. The gain on the sale in 1950 was recognized for tax purposes since the law at that time did not contain the nonrecognition provisions. Such provisions became effective on January 1, 1951. The taxpayer sought nonrecognition of the gain arising from the 1951 sale of ten acres since a new residence had been acquired approximately six months prior to the sale. The Court of Appeals, in *Bogley* 263 F (2d) 746, CA-4 (1959), reversing the Tax Court, indicated that they could not agree with the narrow reading of the statute that the ten acres of unimproved land could not constitute a residence in any sense of the term. It was held that the thirteen acres, intact, were undoubtedly the taxpayer's old residence; also, there is no limitation in the statute, even by implication, that the old residence must be sold in its entirety. The court cited Revenue Ruling 54-156, in which the Commissioner acknowledged that the nonrecognition section may be applicable to the sale of land without a house.

It would seem from a reading of the *Bogley* case that the taxpayer in our example should be able to consider the adjusted sales price from the five sales as arising from the sale of his old residence, and if the total amount is invested in the construction of his new residence, no gain should be recognized.

The *Bogley* case does not throw any light on what date must be used to measure the statutory time limits for nonrecognition of gain. If the sale of five parcels constitutes the sale of the old residence, should the last sale date be used for this purpose since it might be claimed that only on such date was the residence finally sold or would a more conservative approach be to use the date of the sale of the first parcel?

Since the *Bogley* case indicates that each sale of a part of the old residence is a separate transaction, it would seem logical to assume that the date of each sale of the portions of the old residence be compared with the date that the construction of the new residence is commenced and with the date on which it is finally occupied. Nonrecognition should be accorded to each gain realized within the 12 month and 18 month periods specified in the

statute only if the cost of the new residence on the applicable statutory date, computed with respect to each sale, exceeds the adjusted sales price of the portions of the "old residence" disposed of up to the date of such sale. The same "accumulation" principle should also be applicable to sales made during the nonrecognition period if the new residence is purchased rather than constructed.

ORGANIZATION OF FOREIGN SUBSIDIARY —A DILEMMA IN THE "NO RULING" AREA

In previous months we discussed some of the difficulties encountered by practitioners where the Internal Revenue Service will not issue rulings. It was pointed out that the net effect of the Service's stand is to discourage such transactions by leaving their tax status up in the air. But with the issuance of TIR 308 the Service has in effect prohibited certain transactions unless taxpayers are willing to concede in advance that they are taxable.

One situation involved is that of a domestic corporation which is contemplating the organization of a foreign subsidiary. Certain secret processes, technical assistance and information will be transferred to the new foreign corporation pursuant to what is commonly called a "know-how" agreement. After the transaction, the domestic corporation will be in control of the foreign subsidiary. If a new domestic (rather than foreign) subsidiary was involved transfers of property to it would be tax free under Section 351. Section 367, however, provides that the incorporators of a foreign corporation will have a recognized gain unless *before* the exchange, it is established to the satisfaction of the Treasury Department that the exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes.

Thus to avoid recognition of the gain the taxpayer must obtain a prior favorable ruling from the Internal Revenue Service. But, since the issuance of TIR 308, the Service has suspended rulings in this area. While the Service has not explained the reason for its action, the implications of TIR 308 are that the Service is viewing the "know-how" agreement as constituting primarily services rather than property. Section 351 grants tax free treatment only to gains on property transferred; stock received for services is taxable as ordinary income.

The taxpayer contemplating such a transaction today is stymied. He is without a practical course of action if the deal is to be made in this form. To proceed without advance approval will create a tax liability which may be substantial. If he does nothing but mark time, he may see a valuable foreign market fade away.

Therefore, other alternatives must be considered. For example, the domestic parent corporation may establish a branch in the foreign country; or the new foreign subsidiary, if created, could pay royalties to the domestic parent under the "know-how" agreement. Both of these possibilities present certain other drawbacks, but at least action is possible and the dilemma caused by TIR 308 is avoided.

Classified Section

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